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TAX AND FINANCING ASPECTS OF HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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TAX AND FINANCING ASPECTS OF HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS

THURSDAY, JULY 24, 2008

U.S. SENATE,
SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:15 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Jeff Bingaman (chairman of the subcommittee) presiding.

Present: Senators Salazar and Bunning.

Also present: Derek Dorn, Staff Director; and Payson Peabody, Tax Counsel.

OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM NEW MEXICO, CHAIRMAN, SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE, COMMITTEE ON FINANCE

Senator BINGAMAN. Let me welcome all of our witnesses and indicate just at the very beginning of things here that we are going to have to recess at 3:25 to comply with a Senate remembrance that is scheduled on the Senate floor for Capitol Police officers Jacob Chestnut and John Gibson, who were killed in the line of duty 10 years ago on this date. So we will see where we are in the hearing at that time, but we may have to take a short recess at that time if we are still going.

This hearing today is a hearing of the Subcommittee on Energy, Natural Resources, and Infrastructure tax issues. The topic is "Tax and Financing Aspects of Highway Public-Private Partnerships." At a July 10 full committee hearing, CBO Director Peter Orszag told us that spending from the Highway Trust Fund has vastly outstripped increases in revenues at a time when critical surface transportation needs require billions of dollars in additional spending.

That hearing's other witness, GAO's JayEtta Hecker, argued that Congress should clarify national goals and considered the appropriateness of our current funding structure alongside the roles of States and the private sector.

So heeding GAO's advice, I called this hearing today to consider more closely one financing option that has received considerable attention, that is, the sale of concession rights to existing tolled highways. These so-called public-private partnerships have been billed

by advocates as a silver bullet to our surface transportation problems.

The National Surface Transportation Policy and Review Study Commission's January report concluded that public-private partnerships should play an important role in financing and managing our surface transportation program, and the Department of Transportation has provided States with a how-to guide that includes model State legislation.

Already there are two public-private partnership deals that have closed. One was in 2004. The city of Chicago sold Macquarie of Australia concession rights to the Chicago Skyway for 99 years in exchange for $1.8 billion. In 2006, Indiana sold concession rights to the Indiana toll road to a partnership between Cintra of Spain and Macquarie for 75 years, and received $3.8 billion for that.

Investors are also lining up to invest in another project. Governor Rendell has announced a $12.8 billion deal for a 75-year sale of concession rights to the Pennsylvania Turnpike, which, if ratified, would represent the largest privatization of highway infrastructure in our history.

There is no denying the seriousness of our surface transportation funding challenges, but the question is whether our Federal response should be to encourage States to essentially sell off vital components of the interstate highway system.

I personally am open to the role of the private sector, but I have real concerns about this rush into public-private partnerships and its adequacy to replace or supplement a strong and vibrant Federal infrastructure program.

Before we move away from our long-term Federal-State highway partnership, we must better understand the consequences of doing so. To date, there has been virtually no consideration given to the tax and financing aspects of these transactions, yet tax benefits are key to making them economically attractive to private companies. This afternoon our witnesses will assist us in understanding the tax and financing aspects, an understanding that I think will prove essential if Congress is to consider its role in this new phenomenon.

Before turning to our testimony, let me just say how troubled I am that a desire to derive generous Federal tax benefits is driving exceedingly long lease lengths. As our tax attorney witnesses will explain, in order to take advantage of the tax code's 15-year cost recovery period, a lessor must have constructive ownership of the road.

Constructive ownership is generally attained by having a lease that exceeds at least 45 years, which is the Bureau of Economic Affairs' determination of what is its useful life. So parties will not enter these deals unless they are at least 45 years in length, often longer, and they take that position to follow tax advisors' guidance.

What we have, in my view, is the tax tail wagging the dog, exceptionally long leases in order to recover capital outlays on an accelerated schedule. In essence, today's tax code provides a taxpayer subsidy for these companies that far exceeds what economic reality would dictate.

Let me put the remainder of this statement in the record, and go ahead and defer to Senator Bunning, who is the ranking member on this subcommittee.

Senator Bunning?

[The prepared statement of Senator Bingaman appears in the appendix.]

OPENING STATEMENT OF HON. JIM BUNNING, A U.S. SENATOR FROM KENTUCKY

Senator BUNNING. Thank you, Mr. Chairman.

I welcome the opportunity to hear from these distinguished visitors on our panel today about public partnerships with private firms to build and maintain certain highways. We all know how important a healthy and functioning transportation system is to the United States. Perhaps no one knew this better than President Eisenhower, who led the effort to create the modern interstate system over 50 years ago.

President Eisenhower's goal was to link the continental United States together for the age of the automobile. Under his administration, the Highway Trust Fund was created. There are many different models and modes of transportation used by Americans today, such as transit, rail, and aviation, but our highway system and its funding are the reason that we are here today.

Today we are focusing on partnerships to maintain existing State highways that were not built with Federal money, such as the Indiana toll road that was mentioned and the road in Chicago. As the Government Accountability Office stated in written testimony, "Public-private partnerships show promise as a viable alternative to help meet the growing and costly transportation demands. We should not dismiss this private sector alternative out of hand, but we should make sure that our tax laws are neutral across investment types."

The principal of neutrality is a bedrock of our tax laws, and rightly so. Tax laws that are unduly restrictive will starve the transportation sector of capital for new investment and will mean higher costs for government, higher taxes, and deteriorating infrastructure.

As we look at the tax attributes of these transactions, we should be careful to consider the tax benefits available to investors for similar capital-intensive investments such as investments in manufacturing facilities or aircraft. We must put our tax laws in context before we conclude that they are too generous when we focus on one particular type of transaction.

I thank the chairman for holding today's hearing, and I look forward to the testimony and the discussion that follows it. Thank you.

Senator BINGAMAN. Thank you very much.

Let me just introduce our five witnesses, and then ask each of them to give us their views. Starting on the left-hand side of the table—our left, at least—Edward Kleinbard is Chief of Staff for the Joint Committee on Taxation. Thank you for being here. JayEtta Hecker is Director of Physical Infrastructure Issues at the Government Accountability Office. Thank you for being here. Pat Choate is an economist who is director of the Manufacturing Policy Project.

Thank you, Pat, for coming. Linda Carlisle is a tax partner with White and Case. Dennis Enright is principal of the public finance investment banking firm of NW Financial Group. Thank you very much for being here.

Why don't each of you take 5 or 6 minutes and give us the main points we need to understand. We will include all of your statements in the record as if read, but give us the main points and then we will have some questions.

Mr. Kleinbard, why don't you go ahead?

STATEMENT OF EDWARD D. KLEINBARD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Mr. KLEINBARD. Thank you, Mr. Chairman, Ranking Member Bunning. I am pleased to appear before you today to discuss the Federal income tax issues raised by the use of public-private partnerships for brownfield highway projects. These, as you know, involve very long-term leases of existing infrastructure from a State or other public owner to private parties. In my testimony, I have used the structures of two well-publicized transactions as a template, but my remarks should be understood as generic in nature.

The term "public-private partnership" has no tax significance. Indeed, many such partnerships are not partnerships at all in the tax sense. As a result, the tax consequences of these transactions depend on their particular facts and contractual terms. For tax purposes, the archetypal transaction that we are considering today can be seen to comprise three operating relationships: first, a purchase by the private firm of the existing infrastructure, that is, a highway itself and the related improvements; second, a grant by the public owner to the private firm of a right of way, that is, a long-term lease on the public lands that underlie that infrastructure; and, third, a grant of a franchise from the public entity that permits the private party to collect tolls from the highway.

Mr. Chairman, as you have pointed out, these deals are structured as very long-term arrangements, 75 or 99 years, for example. Tax considerations are important drivers of the long-term nature of the arrangements. By leasing the infrastructure assets for a period that clearly exceeds their expected economic life, the firms can treat themselves as the tax owners of the infrastructure. As owners, they are then eligible to claim tax deductions for the depreciation on their investments, just as other asset owners do.

Turning to the tax policy implications, public-private partnership transactions raise, in my mind, two important sets of tax policy questions: first, are the parties to the arrangement engaged in a bona fide commercial transaction, or instead are they primarily trading on the public entity's tax-exempt status to transfer favorable tax attributes from the public sector to the private firm?

I think, here, the answer is that the public-private partnership arrangements of the sort that have been consummated to date appear to be genuine commercial transactions. In particular, they do not appear to present the issues raised by lease-in/lease-out, so-called LILO, or sale-in/lease-out, SILO, transactions which are abusive arrangements that have been curtailed by Federal tax legislation.

The second policy question is, are the tax consequences to the private party similar to the tax results achieved in other economically comparable transactions that take place entirely in the private sphere? Considerations of economic efficiency and consistency would dictate that the tax law should be neutral as between making this type of investment or another type of investment. Or, instead, does the tax law, through tax expenditures, indirectly subsidize this activity? If so, is that subsidy intentional, for example, as an instrument of Federal transportation policy?

I think, here, the answer is that the code's depreciation system can be described as comprehensively non-neutral. The rules arguably grant Federal subsidies in the form of accelerated depreciation deductions for investing in property, plant, or equipment, but in turn, those subsidies are not uniform across different asset classes.

So the practical question here is whether a private investor in a brownfield public-private partnership receives depreciation benefits that in some manner are disproportionate to those available in capital-intensive transactions that take place wholly within the private sphere.

A private investor in a brownfield highway project generally can expect to depreciate its investment in the highway itself and any bridges that it acquires over 15 years using accelerated depreciation methods. Its costs for any intangible assets, like its franchise to collect tolls, also are amortizable over 15 years, but on a straight-line schedule.

It can be argued that the 15-year accelerated depreciation is not the appropriate schedule for highways or bridges. The current rule does not, however, appear on its face to be greatly different from the depreciation benefits afforded other transportation assets. For example, railroad beds are depreciated over 50 years, but rail track over 7, using an accelerated method, and commercial aircraft also are depreciated on an accelerated 7-year method.

Similarly, it could be argued that 15-year amortization of the upfront payment for the franchise is too generous in the context of a toll road where the overall agreement lasts for 75 or 99 years, but the code, today, permits the amortization of a purchased permanent franchise or purchased goodwill over the same 15 years. It, therefore, is not obvious that the code inappropriately favors long-term toll road deals that we are discussing when compared to competing investments.

Finally, a quick note on the financing opportunities available. As you know, qualified private activity bonds are tax-exempt bonds used to benefit a private owner or user, but that advance some public policy by virtue of the nature of the asset being financed.

In 2005, Congress added a new category of qualified private activity bonds, bonds for qualified highway facilities. Qualified highway facility bonds may be used to finance improvements in public-private brownfield highway arrangements, but doing so comes at a price. To the extent that assets are acquired with the proceeds of these bonds, depreciation is calculated using a straight-line method over longer recovery periods than otherwise would be the case.

Interestingly, however, intangible assets available for the 15-year amortization rule that I described are not affected by any slowdown if acquired with tax-exempt financing.

I would be pleased to answer any questions that you might have.

[The prepared statement of Mr. Kleinbard appears in the appendix.]

Senator BINGAMAN. Ms. Hecker, why don't you go right ahead?

STATEMENT OF JAYETTA Z. HECKER, DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Ms. HECKER. Thank you very much, Mr. Chairman, Senator Bunning. It is an honor to be here.

What I will be doing is summarizing a recent report that we have done looking both domestically and internationally at the use of public-private partnerships in the highway sector.

The three points that I will cover are: first, what are the benefits, costs, and trade-offs of these deals, both domestically and internationally? The second question is, how have public officials acted to protect the public interest, what kind of process do they go through, what kind of analysis do they do? And, finally, what has the Federal role been? What kind of review do they have, what kind of hook do they have on these deals?

The issue of the benefits is one that we could talk about for a long time, but I will very briefly say the major benefit is on the sharing or the transfer of risk. There is a lot of risk in building highways, construction risks, traffic risks, and a lot of uncertainty. Part of the benefit of these deals is that the private sector is very good and, in some places, potentially better than the public sector at quantifying and pricing those risks. There are also increased efficiencies. You get a life cycle management. The public sector traditionally has not taken a life cycle approach to roads. These are long-term assets. But they build them and then, as they can, they figure out when it is time to replace or when it is time to repair or renovate. These deals basically have the built-in long-term responsibility; it is taken care of for the life of the concession, the full life cycle management of that asset.

Another benefit is the private sector profit motive. You potentially get a lot more innovation, customer service, use of information technology, and more efficient methods of tolling. Public toll authorities have traditionally not had well-defined tolls and efficiently managed tolling programs, and private entities do a really good job of better recognizing what the full costs of operating that road are, the benefits received by the users, and pricing the road more efficiently.

The foreign benefit, where these have been used extremely widely, are most of their major highway systems were built with these partnerships. So this is not just kind of at the margin, the way we are seeing it starting to develop here. In some countries—Australia, Spain—the whole network was built through these deals. From the public perspective, the benefit is that it is off the public books. They recognize that it has costs, but basically these countries did this, in Europe, for example, to be able to join the European Union. You had to have a very, very tightly managed fiscal policy, and there was just no view whatsoever that they could build the roads without turning to the private sector.

There are, however, potential costs and trade-offs. It is a concern that there are views that this is somehow "free" money. You cash out, particularly on these brownfield or existing assets. You just cash it out and there is this windfall. The reality is, these techniques are probably going to result in higher tolls to the users because of the way they have been managed relative to a publicly owned toll road. There are lots of other costs and issues which I discuss in my written statement.

As to the tax issues, I can say that our work has been confirmed by all the parties in Indiana and Chicago. The length of the deals, as you said, Mr. Chairman, was largely dictated by eligibility for demonstrating effective ownership for tax purposes, and those benefits were seen as substantial and definitely increased the amount that the State was able to cash out or monetize from the asset. So, it played a big role.

The second issue: what kind of strategies do States or other countries use to protect the public interest? In the deals that we looked at domestically where this process is just beginning, a lot of the focus is on the contract terms. While these protections are important, overseas they have much more rigorous, up-front analyses, very multiple-staged reviews of public interest, multiple dimensions. They have public sector comparators, how it compares to what the public sector could do, and those are very, very distinct, very well developed, and really represent an opportunity for a lesson learned in the U.S., and that was one of our main recommendations.

The final question, which of course is important to the Congress, is what is the Federal role? The Federal involvement in these projects was very limited because the Federal hook on these deals is related to the amount of Federal funds involved in them.

As you said, correctly, many of these facilities were built with State funds. Federal funds, for the most part, were limited. The concern that we have is that there really is no focus at the Department on what the national interest may be in these deals and what the review process might be. There is some ambiguity in current law about rate of return, which is potentially a very important factor.

To wrap up, though I hope we can get into many of these in more detail, there are really some important promises and benefits of these deals, and they do bring money to the table.

It is borrowed money, but we are out of money, and these bring rigor and structure to some environments and have promise. They need to be adopted in rigorous, up-front ways where all of the risks are understood and mitigated and we do not have some unintended consequences of perhaps putting more burden on the users of that toll road than is appropriate.

Thank you, Mr. Chairman. That completes my statement.

Senator BINGAMAN. Thank you very much.

[The prepared statement of Ms. Hecker appears in the appendix.]

Senator BINGAMAN. Mr. Choate, go right ahead.

STATEMENT OF PAT CHOATE, ECONOMIST AND DIRECTOR, MANUFACTURING POLICY PROJECT, WASHINGTON, VA

Mr. CHOATE. Thank you, Mr. Chairman, Mr. Bunning.

I have been invited to provide an overview. What we are talking about on highways is being experienced nationwide. What we are seeing is massive under-investment across the board. I prepared a table to show you, today, an estimate of just what this meant from the period 1960 through 2006. What we have seen during that period in terms of real investment is a decline of 44 percent, and at the same time we have seen a 66-percent increase in our population inside this country.

For highway investments, the primary problem has been that the gas taxes have not been indexed for inflation, and they have not kept pace over time. The last change was in 1993. The gas tax at this point is about 18.3 percent. If it were indexed for inflation, it would be nine points more. To put that into context, what you could buy for $1,000 in 1993, you can only get $700 worth of today. That is the primary problem that we face on the financing of these roads.

These PPP arrangements are a substitute for the absence of public monies. The system that we have long used, going back into really the Roosevelt administration, was officially put into place by President Eisenhower, and the financing system that we have, the pay-as-you-go, was designed by Senator Prescott Bush of Connecticut, when he was a Senator, the President's grandfather. That system has worked well, as long as we kept it indexed for inflation.

As we take a look at these projects, the first ones, there are some real questions on policy, I would think, for the public sector. In the Chicago deal, on the $1.8 billion, most of the money was used for things other than transportation, including making up the $200 million deficit for the city of Chicago. On the $3.8-billion deal for Indiana—a toll road that was built, incidentally, with the promise that when it was paid off it would be made a public road, but was not—that money has been used to give to counties in the surrounding area, fund other roads, and various purposes of general government.

For the Texas roads that are being put into place, there are several different models in use there. But the key points on those roads are, they are being used not just to simply provide transportation at the best cost, they are being used to also finance State government. In other words, a transport tax is being imposed through those roads. Up-front monies are being collected to take what are existing public roads and convert them to tolls. At the present point, of the highway monies collected in taxes, more than 25 percent are diverted to other functions to fund the general fund of the State government.

The Governor of Texas has submitted a proposal to Congress, asking that the U.S. sell back to the State of Texas its interstate highways at the prices that were originally paid in the 1950s and 1960s to construct those roads, and those roads would be converted to toll roads.

Taking a look to the future, when one takes a look at doing the analysis, the first thing that one sees at the national level is that the principal problem is that the national government does not

have a national capital budget. Every State government has a capital budget, every corporation has a capital budget. The Federal Government does not have a capital budget that determines priorities and looks at the things that Ms. Hecker called for. That is a major fiscal omission.

The second thing, when one takes a look at the PPP substitute for public financing, is the projects that will draw attention are the ones where you have massive congestion. I submitted as part of my testimony a map that had been put together by the Federal Highway Administration, and it identified where the congestion would be in the year 2020. That is about 20 percent of the roads in the country. Those roads will be attractive for high tolls. The rest of the country, the question is, how will the Federal Government and how will the States finance those, where you have the long runs in States such as New Mexico and such as in Kentucky, and the balance of the West?

I have other questions that I raise in my paper that deal with the question of, with these long profits to private firms, if we must use tolling instead of public authorities that will turn the roads back to the public, what is the incidence of tax, what is the equity of the tax, and particularly, what are the consequences when you have projects such as are being built on I–95 here, when the Federal Government is putting up $1 billion of the $1.7 billion or $1.8 billion that is being financed? It is not simply a tax question, it is a question of the Federal Government putting up money. The Department of Transportation reports that there are, at present, some $75 billion of applications for those particular monies. I think those are also significant.

I look forward to your questions.

Senator BINGAMAN. Thank you very much.

[The prepared statement of Mr. Choate appears in the appendix.]

Senator BINGAMAN. Ms. Carlisle?

STATEMENT OF LINDA E. CARLISLE, PARTNER, WHITE AND CASE, LLP, WASHINGTON, DC

Ms. CARLISLE. Mr. Chairman and members of the committee, thank you so much for inviting me to speak. My name is Linda Carlisle. I am a partner with White and Case in Washington.

I have provided advice regarding the Federal income tax treatment of transactions involving private investments in public toll roads in the United States to U.S. and foreign investors. With increasing frequency in the past few years, State and local governments have sought to obtain funds for infrastructure development and maintenance from private investors rather than from tax revenues or from issues of tax-exempt bonds.

These privatization transactions result from a competitive bidding process through which the most qualified and the most well-funded private investors are awarded the right to enter into the privatization transactions. Authorization for the State or local government to enter into the transactions typically requires the approval of the legislative body of the government.

Investments in public toll roads are attractive to private investors because toll roads are, or may, produce predictable cash flows and growth potential, they provide returns on investments that

have a low correlation to other asset classes, and they provide predictable returns over relatively long periods.

Private investments may be made with respect to existing toll roads or may be made with respect to new toll roads. My oral testimony will focus on brownfield projects, which we have been discussing today: existing toll roads.

Private investment in an existing toll road typically takes the form of a concession and lease agreement for the lease of the toll road and the grant of the right to toll the road over the term of the agreement. The concessionaire, an entity typically treated for tax purposes as a partnership, is required to make an up-front payment to the State or local government. This is typically funded with equity and debt from third-party lenders.

The concessionaire also may be required to make payments back to the local government during the term of the agreement if specified windfall toll revenues occur or if there are specified refinancing gains during the term of the agreement.

The term, as earlier panel members have discussed, gives the concessionaire possession and use of the toll for a period that exceeds the estimated remaining economic life of the road, normally between 75 and 99 years.

The concessionaire agrees to pay all costs and bears all risks relating to the operation of the toll road, including any casualty losses. The State or local government will typically retire or legally defease any outstanding tax-exempt bonds that are secured by the toll road or by revenues from the toll road.

Through such brownfield projects, State and local governments are able to monetize the fair market value of a toll road in order to use the proceeds to fund other capital needs and shift the burden of the toll road during the term of the agreement to the private investors. The U.S. Federal income tax treatment of private infrastructure transactions in brownfields mirrors the tax treatment of other investments in property in the United States.

Since the concessionaire is a flow-through entity, the entity itself is not subject to Federal tax, but U.S. and foreign individuals and corporations that are partners are subject to U.S. Federal tax on their distributive share of the income of the partnership, regardless of whether it is distributed to them. Dividend distributions by corporations that are partners in the concessionaire are subject to 30-percent withholding tax if they are paid to non-residents.

In addition, non-U.S. shareholders of U.S. corporate partners or members of the concessionaire may be subject to U.S. Federal tax on gains from the disposition of their shares in the U.S. corporate partner if such U.S. corporate partner is deemed to be a U.S. real property holding corporation.

In a typical agreement, the concessionaire acquires ownership for tax purposes of the real property improvements. The concessionaire also acquires a lease of the land on which the toll road is located, ownership of any tangible property conveyed as part of the road—signage—any goodwill or going concern with respect to the road, and the right to charge and collect tolls. Government licenses, permits, and franchises that are not interest and land are section 197 intangibles, which, under current law, are amortizable on a straight-line basis over 15 years. In many States, private persons

are prohibited from operating toll roads or charging tolls without the express permission from the State.

In such States, the license or franchise to toll a toll road should not be treated as an interest in land because it is not a right that is part of the ownership or lease of the land. Accordingly, in such rights the right to charge and collect tolls for the use of public land should be considered to be a 197 intangible, amortizable over 15 years.

The concessionaire should be able to depreciate the real property improvements acquired, and other tangible property under "MACRS," the Modified Accelerated Cost Recovery System. But in brownfield projects, the original construction of the road may very well have been through tax-exempt bond financing at the local or State level. MACRS depreciation is not allowed for tax-exempt bond-financed property. It is unclear whether property that is acquired from a local government in all cases would be able to be depreciated under MACRS.

If a U.S. corporate member of a concessionaire is a U.S. real property holding company, gain on the sale of the stock would be subject to the FIRPTA, or Foreign Investment and Real Property Tax Act, withholding tax. Again, that may or may not depend upon whether the right to charge tolls is an interest in land.

In conclusion, the up-front payment made to a State or local government in a brownfield is in exchange for the transfer of the ownership of the real property improvements, lease of the land, government franchise, and any goodwill. The cost of such assets may be depreciated for tax purposes.

A U.S. or non-U.S. investor is engaged in a business in the United States and pays tax on income earned from the project. These are the same results that would apply in any acquisition of a U.S. business. Accordingly, there are no unique rules that enhance the tax benefits of brownfield transactions. To the contrary, because most brownfield projects may have been financed with tax-exempt bonds, private investors in a brownfield may receive less tax benefits.

In summary, private-public infrastructure investments provide needed infrastructure for State or local governments with no extraordinary tax benefits to the private party.

I would be pleased to respond to any questions.

Senator BINGAMAN. Thank you very much.

[The prepared statement of Ms. Carlisle appears in the appendix.]

Senator BINGAMAN. Mr. Enright?

STATEMENT OF DENNIS ENRIGHT, PRINCIPAL, NW FINANCIAL, JERSEY CITY, NJ

Mr. ENRIGHT. Thank you, Mr. Chairman, members. I appreciate being here today.

We have undertaken analyses and written reports on both Chicago and Indiana, as well as other toll roads. We are here to talk about the relationship of those projects to the issues at hand in infrastructure finance.

Over the last 2 years, ever since the Chicago Skyway public-private partnership transaction, the 99-year lease, there has been

much discussion and debate on the need and/or value of having private operators take over long-term ownership financing and operating obligations of U.S. infrastructure assets which to date have been the responsibility of public bodies.

Most of the focus on utilizing the private sector has been to tout two advantages: (1) the availability of investment capital in the billions; (2) infrastructure management that is more focused on profitability. In my view, these two alleged advantages have been promoted without a thorough review of the impact upon the general public that utilizes infrastructure assets, and in the end must pay for them through some form of user fees. Additionally, it is important to note there is no shortage of investment capital available to fund public sector-owned and -operated infrastructure.

Second, with rare exception, most publicly owned and operated infrastructure is run just as efficiently as any private operator would. Any cases of higher operating costs are almost always directly related to the higher cost of fringe benefits in the public sector for health care insurance and pensions rather than any lack of operating talent.

An often misused measure of both private investment interests in infrastructure investment and public sector lack of efficiency is EBITDA, Earnings Before Interest, Taxes, Depreciation, and Amortization, or pure cash flow from operations is really what it reflects.

Publicly owned and operated infrastructure has little positive cash flow because the public mission is to provide affordable services to its customer base. As a result, when infrastructure has been sold to private interests, these sales have been hailed as successful because they were purchased at very high multiples to EBITDA, multiples to cash flow perhaps 20 to 30 times EBITDA when typical private-to-private sales would be at 10 to 15 times EBITDA, thus giving the impression that the private sector can run the assets more efficiently and, therefore, is willing to pay a higher price.

In reality, the price is not established in relationship to historical EBITDA, but is based upon projected future EBITDA, which is largely driven by the massive increase in rates allowed in the P–3 model. As an example, if the toll rates granted to the private buyers of the Chicago Skyway were applied retroactively to the Holland Tunnel from its opening in 1929, the toll at the Holland Tunnel today could be $185 rather than the $8 that is collected.

Another misconception is created by promoters of privatization, creating new metrics that support their case. The presentations of these new measures often sound compelling, but upon review they are often revealed as voodoo economics.

Recently in the battle over the leasing of the Pennsylvania Turnpike, one advocate for privatization used the metric of operating expenses as a percentage of revenues as a measure to prove alleged inefficiency of operations. In reality, this is a bogus measure, since the lowest toll rate's possible goal of a public authority drives a de facto result that their debt and operating expenses consume almost all of their revenue.

In fact, the Pennsylvania Turnpike maintains one of the three lowest toll rates per mile in the country, at about 5 cents, and therefore its expense will reflect the higher percentage of revenues. This would not be true in the hands of a private operator who must

increase tolls to squeeze out a profit margin. The true measure of efficiency is the operating cost per mile of toll road, and the Pennsylvania Turnpike would score well for efficiency using this metric.

Private infrastructure in the United States. The utilization of the private sector to provide infrastructure in the U.S. has deep roots that go back to the 18th century when private tolls were common. Today, although there is still much private infrastructure, it is largely focused on areas where the private sector has taken technology and market acceptance risk.

The infrastructure involved can be divided into two distinct classes of assets: regulated utilities and risk transfer assets. Regulated utilities include electric, water, sewer, telephone, cable, etc. Risk transfer assets include solid waste technology and health care collections.

In both categories, the public sector and the end users were protected either through pricing regulation or through elimination of risk. The history of private ownership was largely due to an undeveloped public ownership model, and also the need to install the infrastructure across multi-jurisdictional boundaries at a time when regional entities were not a commonplace solution.

In the case of some of the oldest forms of private infrastructure, like electricity and telephone, there was also uncertainty as to how successful these "new" technologies would be since the public needed to pay for them, much like many of us said years ago, we would never pay for TV since we could get it free over the airwaves.

These types of technology and businesses are appropriate for the private sector to lead; however, the public sector has always looked to pricing and open access regulation as a method to protect the public. One only need look at the deregulation of the electric markets in California in the past decade for an example of why utility regulation is appropriate.

The risk history of private enterprise providing infrastructure assets to serve the public continues today largely because that is how it was first established and because it is working in a price and quality controlled manner that is overseen by public officials whose interests are to protect the consumer.

Infrastructure finance is not very different from real estate finance. Most people understand that to some degree. And, in real estate finance, an income-producing property becomes the collateral for a loan, and the rents that are charged are set at a level sufficient to repay the loan and return a profit. The higher the interest rate on the loan, the higher the return on equity to the owner, then the higher the rents.

Infrastructure is not different. The cost of installing and operating a water plant, sewer lines, or roads will need to be recovered from the rates, charges, and tolls that users of the infrastructure will pay. Once again, the higher the cost of capital, the higher the user charges will be.

Equity investment is often looked at as a cheap form of capital by the public sector. In reality, it is the most expensive form of capital. It requires returns of 10 to 20 percent. Certainly equity investors do not require instant returns on their capital and can wait to achieve that return, but that accrued return will ultimately be built into the rates that the users will pay.

In the Chicago and Indiana transactions, and others such as Pennsylvania, which is pending, the role of leverage becomes important because, at 10 or 20 percent, the valuation of an asset would be extremely low. So the investment teams were incentivized to create what is called a weighted average cost of capital by using leverage, meaning borrowing in combination with equity investment.

In the case of Chicago and Indiana, this borrowing was typically 80 percent debt, 20 percent equity. In the case of Pennsylvania, with the crisis in the credit markets, it has changed to 60 percent debt, 40 percent equity. The lower leverage—meaning less debt, which is a cheaper form of capital—has increased the cost of capital to over 9 percent in the Pennsylvania case, from an expected range of 7 to 8 percent. This resulted in lower than expected bids from the private sector.

It is important to note that a public authority could access the capital markets at rates near 5 percent for the same transaction. The lower the cost of capital, the higher the valuation of the asset up for sale. Our past analyses have shown that a public sector funding model will produce a value at least 30 percent greater than a private ownership model, or could produce the same valuation with 30 percent lower user charges.

Thank you.

[The prepared statement of Mr. Enright appears in the appendix.]

Senator BINGAMAN. Thank you all very much for your testimony.

Why don't we do 5-minute rounds here? Let me start.

One thing I am not real clear on, Mr. Kleinbard, and any of the rest of you, maybe Ms. Carlisle, you explained in your testimony that the long length of these deals is driven by a desire to attain depreciation benefits that are more generous than economic reality would dictate. That was what I understood you to say.

Ms. CARLISLE. That is what Mr. Kleinbard said.

Senator BINGAMAN. Mr. Kleinbard said that. All right.

In particular, concessionaires seek to depreciate highways on a 15-year schedule. If, after the 15-year period, the firm sells the lease to another concessionaire and there are still 45 years left on the lease, what would be the tax consequences? Is the successor company then able to write off its costs over 15 years, too?

Mr. KLEINBARD. Yes. If the first concessionaire were to transfer the lease, effectively it would be selling the property to the second concessionaire. As a result, the second concessionaire—assuming they are unrelated parties—would obtain a new cost in the property and would be able to depreciate it, again, over 15 years.

However, the first concessionaire would pay tax on its gain. If you sum the two of those up, the government actually comes out the winner because we collect the tax up front from the seller, and the value to the buyer of the refreshed depreciation takes place over 15 years. So, net, actually the government is the winner in that case.

Senator BINGAMAN. All right.

Let me ask Pat Choate, my understanding is that part of these deals—at least I think the one in Indiana, maybe others, too—is that they have a non-compete clause in there.

Mr. CHOATE. Yes.

Senator BINGAMAN. How does that work? I mean, I guess I have real trouble seeing how the government, by contract, commits itself not to build roads if congestion or whatever dictates that additional highways are needed. I think it would be hard for a Congress to say, well, we cannot do anything, or hard for a State legislature to say we cannot do anything, because 40 years ago the State agreed not to build any roads in this part of the State. Is that what a non-compete clause provides? How do these things work?

Mr. CHOATE. In these first ones, they were called "non-compete clauses." In the Virginia contract they are called "compensation events." But the non-compete clause—for example, in the Indiana deal—is 10 miles on either side of that highway. If the State makes improvements in roads that adversely affect the traffic on the Indiana highway, then the State is obligated to compensate the concessionaire for the money that is lost.

On the deal that is going into place in Virginia, the arrangement is, on these HOT tolls that, if you get the traffic over, I think it is 24 percent over some level, I think it is 3,200 or 3,500 cars per time period, then the State is obligated to pay the concessionaire 70 percent of what the toll would be. These are open-ended deals. I think the Virginia deal goes for 40 years.

The Texas deal had the 20-mile, 10 on each side, provision on the trans-Texas corridor arrangement. This has caused a great deal of concern for the people in Texas, saying, for example, if you do a greenfield, which that deal was originally proposed to do, and it runs along the side of I–35, and the State decides to really improve I–35, then there would have to be some sort of arbitration on how much traffic was diverted off of the trans-Texas corridor, and the State, again, would be obligated to pay. The alternative is, as the tolls go up and the State does not improve, then what you see is a deterioration of side roads as people seek out a free road to drive. That is what has happened in Mexico, for example, on their toll roads.

Senator BINGAMAN. Senator Bunning?

Senator BUNNING. Thank you.

Mr. Choate, I understand you are opposed to politicians who promise not to raise taxes by signing a "No Tax" pledge.

Mr. CHOATE. As a general——

Senator BUNNING. Well, wait. Let me get my question out before I get a response, if that is all right with you.

Mr. CHOATE. All right.

Senator BUNNING. You prefer those who would want to raise taxes on middle-class taxpayers—who are paying today Federal, State, and local taxes, including gas tax, sales tax, telecommunications tax, tolls on roads, property tax, and other indirect taxes. Perhaps you would also want a carbon tax. When you add it all up, the burden is well over 50 percent. But you obviously think that is not enough. Why not 60 or 70? With the new Medicare law that we just passed, it probably will be, in 2011, well in excess of 60 percent. If you think you can impress voters by promising to raise taxes, I encourage you to give that a try in the 7th congressional district in Virginia, where your Manufacturing Project is based. Do you have any plans to run for office, Mr. Choate?

Mr. CHOATE. In 1996, I was at a party with Senator Bingaman, and he very wisely advised me. He said, "Choate," having run for vice president with Ross Perot, "whenever you lose by 32 million votes, I think you can take that as a mandate from the American people to stay in the private life." So, I am taking that advice, definitely. [Laughter.]

Senator BUNNING. Thank you very much. And by the way, in Kentucky——

Senator BINGAMAN. I do not remember saying that, just for the record.

Senator BUNNING. That is all right. [Laughter.]

Mr. CHOATE. But it was wise advice.

Senator BUNNING. I have a couple more questions. In Kentucky, all parkways, east, west, north, south, were built by Kentucky State dollars, roads that spanned Kentucky. The only time we got to the interstate system was when Dwight David Eisenhower became president, and now we have two interstate highways in Kentucky, one north/south, one east/west.

The rest of our main roads are all parkways: the Bluegrass Parkway; the Western Kentucky Parkway; the Daniel Boone or, as it is now called, the Hal Rogers Parkway; the Louie Nunn Parkway; the Martha Layne Collins Parkway; the Ned Breathitt Parkway. Those were all built by Kentucky taxpayers, and we are not selling any of them, at least presently. With the situation we have in Kentucky there may be a plan to do just that, because we are hurting financially, both in the road fund and in the general fund.

Ms. Carlisle and Mr. Kleinbard, some have said that public-private partnerships for highway maintenance or new construction have features in common with tax shelters. Can you comment on why the comparison is being made, and why do you believe this is not an area that the Finance Committee should be concerned about from a tax shelter perspective?

Mr. KLEINBARD. Does Ms. Carlisle want to go first?

Senator BUNNING. Either/or.

Mr. KLEINBARD. Go ahead.

Ms. CARLISLE. As I said in my testimony a few moments ago, the tax benefits that are afforded to the investors in a private-public infrastructure partnership are exactly the same as they would be in any business operation in the United States. In a SILO or a LILO, as Mr. Kleinbard referenced earlier, tax benefits were bought—and I will use that word—in transactions with no true business purpose. That is one side of the spectrum.

These transactions that we are referencing are just like any other acquisition of a business. Indeed, we are taking toll revenues which would be not subject to tax because they would inure to the government, and we are making that taxable income to the private sector. Yes, there are depreciation benefits allowed because it is the acquisition of a trade or business, but as those benefits may not mirror economic depreciation, that is a tax policy choice that the Federal Government has made. It is not a unique structure for infrastructure deals. I cannot answer the first part of your question, which is why people are viewing these as like SILOs and LILOs.

Senator BUNNING. Maybe Mr. Kleinbard has an idea why, or maybe not. Go ahead.

Mr. KLEINBARD. Well, I have three thoughts. First, the word "tax shelter" means whatever you choose it to mean. But it does not, by itself, have a lot of content. I think the reason for the confusion is that these transactions involve the public sector and the private firm and a lease, and that sounds sort of like the SILO and LILO transactions.

But the difference is that in those cases the lease went the other way. The critical lease went from the private nominal owner back to the public sector, so it was the public sector that continued to have all the economic risks and rewards of operating the facility, and it was the public sector as lessee that had the obligation to maintain the facility. And it was the public sector that had, in effect, an obligation even to reacquire the facility at the end of the lease term. None of that is present here. Nonetheless, what Ms. Carlisle says, of course, is correct in the sense that the depreciation and other benefits given here are not unique.

But there is a way of looking at these transactions that was identified either by Mr. Choate or Mr. Enright that is worth keeping in mind, and I think, as Ms. Carlisle also said, these are long-term transactions with very predictable income streams. When you have a long-term asset with predictable income streams, you have a highly bankable asset, one that you can finance in the private markets easily.

The result of that is very similar to a high-quality office tower, for example, with net leases where the owner can borrow a good deal of money, secured by the building. So, too, here, the owner of the facility has, long-term, the ability to leverage the facility to an extent that would not be true, for example, of any other——

Senator BUNNING. I am sorry. My time has expired. Thank you.

Senator BINGAMAN. You can go ahead, if you would like.

Senator BUNNING. No, that is fine.

Ms. CARLISLE. Mr. Bunning, could I possibly add something to Mr. Kleinbard's comment?

Senator BUNNING. Well, we are already past, 3 minutes past. So, the chairman is——

Senator BINGAMAN. Go right ahead. I am not in any great hurry to ask my next question, so go ahead.

Ms. CARLISLE. Thank you, Mr. Chairman.

I always agree with Mr. Kleinbard, or generally agree. The one distinction I would make is, particularly with respect to toll roads, they are not like a net lease of an office building. These are businesses that require drivers. There have been, with respect to Indiana toll roads, Chicago's Skyway, and the recent deals that have been done, a marked decrease in what traffic expectations were in pricing the deal.

I said it is a predictable cash flow generally. My clients would argue that they have to maintain the toll road to make sure that it is predictable. This would go to Ms. Hecker's point about the technology that goes into operating a toll road, and they have to hope that people continue to drive. So I just would argue with Mr. Kleinbard that it is not quite as predictable a cash flow as a long-term bond.

Senator BUNNING. Thank you.

Ms. CARLISLE. Thank you.

Senator BINGAMAN. Mr. Enright, maybe I am reading too much into your testimony, but my impression is that it is your conclusion that the public sector can finance road infrastructure more cheaply than the private sector can, and therefore these so-called public-private partnerships wind up costing people more in the long run than if the government just went ahead and maintained the roads.

Mr. ENRIGHT. You are correct. The public sector is in the position to deliver a much lower cost of capital, and therefore keep the user charges as low as possible. The private sector is incentivized to make a profit. That is their job. We did separate analyses on both Chicago and Indiana, very extensive, and concluded that in both cases the public sector could have done just as well and held onto the asset and charged people lower tolls and raised the same amount of money. The problem in infrastructure in the country is not capital. The problem is a willingness to charge people for the infrastructure that they want to use.

Senator BINGAMAN. Right.

Now, Ms. Hecker, you were suggesting that in Europe, for example, and in other industrial countries they do a much better or more rigorous analysis before entering into these kinds of projects than was done in the case of Chicago or Indiana. At least, I thought I heard you say that.

Ms. HECKER. Precisely.

Senator BINGAMAN. And I guess what I am hearing from Mr. Enright is, had such an analysis been done in those cases, the decision would have been made not to enter into the transaction. Do you have any views on that?

Ms. HECKER. I do not think it is necessarily that they would not go ahead with the transaction. I think there are opportunities to gain benefits and efficiencies. I do not think the full costs were very transparent. I do not think they were detailed. I do not think potential impacts of transfers from the interstate commerce that would fund this, transferring that to lower State roads was really evaluated.

I think there were a host of issues that were not fully evaluated. I have to agree that the cost of the borrowing part of this is more expensive, even with the PAB. So there is no doubt that this is a premium way to go about building or maintaining a road but, if you give effective transfer of risk, if you get some assurance of certain public benefits——

Senator BINGAMAN. When you say a premium way, you mean an expensive way.

Ms. HECKER. It is more expensive for the private sector to borrow or to use equity than it is for the public sector to use municipal debt.

Senator BINGAMAN. Right.

Ms. HECKER. But it is whether you get enough benefits in exchange. There are no deals in Europe or anywhere where they monetize the asset the same way we have seen here. We never saw that anywhere.

Senator BINGAMAN. Explain that a little more.

Ms. HECKER. The focus in both Chicago and Indiana and in many of the other deals now is, to the advisors: get me a deal that maximizes the cash that I can take out of this asset.

Senator BINGAMAN. Right.

Ms. HECKER. And they take pride that their whole bidding was a piece of paper with a single number on it.

Senator BINGAMAN. Right.

Ms. HECKER. Their whole focus. In Australia, in Europe, in other places, there is competition and the bid is for the lowest toll.

Senator BINGAMAN. So the competition in these other countries is who can keep the tolls the lowest?

Ms. HECKER. In some of the cases, that is the way the bid takes place.

Senator BINGAMAN. Rather than who can give the government the biggest up-front payment.

Ms. HECKER. Right. So it is not that the analysis would say it will never show that it is a good deal. You would get a better idea of how you can assure that you generate the benefits and that they justify the higher costs.

Senator BINGAMAN. Mr. Kleinbard, did you have a comment?

Mr. KLEINBARD. I did, sir. I wanted to add a footnote to Mr. Enright's and Ms. Hecker's comments about the cost of capital. It is true that public debt is cheaper than private debt, but the reason is, to a limited extent, credit rating, but more directly it is because of a Federal subsidy in the form of tax-exempt interest. So we spend $30 billion a year, the Federal Government does—$30 billion a year—in subsidizing tax-exempt financing at the State level.

So, when you talk about the cost of capital to a State, what you are really talking about is how large a Federal subsidy is going to be given in the form of the tax-exempt interest as opposed to the Federal subsidy in the form of accelerated depreciation in the private sector, for example. That makes the comparison fairer, but it also makes it more complicated.

Senator BINGAMAN. Your comment, Pat, I think in reference to what is going on in Texas, you were talking about a transport tax being imposed through the use or establishment of these roads. Is it fair to say that what we are doing here, in order to avoid raising a gas tax, in order to improve highways, you have this device of establishing or selling off roads for toll roads as a way of essentially transferring that over to a transport tax?

Mr. CHOATE. Yes. And it is not just simply financing roads, it is financing—in Texas, 25 percent of that money goes to fund education and other functions of State government. So, basically what we have is, transport is being taxed to finance other activities. The political responsibility and risk of raising those taxes, tolls, is being contracted out to, in effect, the concessionaire.

What is troubling to me about the way this is being done, particularly listening to Mr. Enright's conclusion, if we could do it as a public deal for 30 percent less, that seems to be very attractive, on limited public resources. The pattern in the past has been, on many tolls roads, when they are completed and they are paid off, they are made freeways again.

The philosophy, at least for the past 60, 70 years of the United States on our transportation policy, is to provide the very best service at the very lowest cost because of the externalities that are involved with our economy, of locating business, moving people to deal with an urban land design that has moved more and more to-

ward commuters. This reverses that policy. This is an historic shift in policy.

This is, as Mrs. Hecker says, to maximize the revenues that are coming off of those roads. In many ways, that can be maximized by just plotting a curve and just saying, all right, what is the maximum rate we can get, and that may involve fewer cars. You may raise it where you can substitute fewer cars for the maximum rate. So this is an historic shift in national policy that we are going through.

Senator BINGAMAN. Well, I think all of this has been very useful. As I indicated before, I need to adjourn the hearing because of this ceremony on the Senate floor. But I think we have gotten most of the points out that people wanted to make, and I appreciate the full testimony everyone has provided. We will follow up with you and perhaps have another hearing down the road.

Thank you very much.

[Whereupon, at 3:24 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Chairman Jeff Bingaman
Subcommittee on Energy, Natural Resources, and Infrastructure
Opening Statement, July 24, 2008

Good afternoon, and welcome to this hearing of the Senate Finance Subcommittee on Energy, Natural Resources, and Infrastructure. Our topic today is "Tax and Financing Aspects of Highway Public-Private Partnerships."

At a July 10 full Committee hearing, CBO Director Peter Orszag told us that spending from the Highway Trust Fund has vastly outstripped increases in revenues, at a time when critical surface transportation needs require billions of dollars in additional spending. That hearing's other witness, GAO's JayEtta Hecker, argued that Congress should clarify national goals and consider the appropriateness of our current funding structure alongside the roles of states and the private sector.

Heeding GAO's advice, I have called today's hearing to consider more closely one financing option that has received considerable attention: the sale of concession rights to existing tolled highways. Indeed, these so-called "Public-Private Partnerships" have been billed by advocates as a silver bullet to our surface transportation problems. The National Surface Transportation Policy and Revenue Study Commission's January report concluded that "public-private partnerships should play an important role in financing and managing our surface transportation program" and the Department of Transportation has provided states with a "how to" guide that includes model state legislation.

Already, two Public-Private Partnership deals have closed: In 2004, Chicago sold Macquarie of Australia concession rights to the Chicago Skyway for 99 years, in exchange for $1.8 billion, and in 2006, Indiana sold concession rights to the Indiana Toll Road to a partnership between Cintra of Spain and Macquarie for 75 years, in exchange for $3.8 billion. Both deals have generated significant interest from the press, the financial community and, now, state and local governments across the country. Investors are lining up for the piece of what is believed to be a very lucrative pie. Most recently, Governor Ed Rendell announced a $12.8-billion deal for a 75-year sale of concession rights to the Pennsylvania Turnpike, which, if ratified, would represent the largest privatization of highway infrastructure in U.S. history.

There is no denying the seriousness of America's surface transportation funding challenges. But the question is whether our federal response should be to encourage states to essentially sell off vital components of our interstate highway system. I am open to a role for the private sector, but I have real concerns about this headlong rush into public-private partnerships and its adequacy to replace or supplement a strong and vibrant federal infrastructure program.

Before we move away from our longtime federal-state highway partnership, we must better understand the consequences. There has already been some Congressional attention paid to the pros and cons from a transportation policy standpoint. But to date, there has been virtually no consideration given to the tax and financing aspects of these transactions. Yet tax benefits are key to making these transactions economically attractive to the private companies. This afternoon, our witnesses will assist us in understanding the tax and financing aspects—an understanding that will prove essential as Congress considers the role of private entities in the future of our interstate system.

Before turning to their testimony, I would like to say how troubled I am that a desire to derive generous federal tax benefits is driving exceedingly long lease lengths. As our tax attorney witnesses will explain, in order to take advantage of the tax code's 15-year cost recovery period, a lessor must have constructive ownership of the road. Constructive ownership is generally attained by having a lease that exceeds the 45-year period that the Bureau of Economic Analysis says is a road's "useful life." And so parties will not enter these deals unless they are at least 45 years in length—and often longer, to follow tax advisors' guidance to be cautious. What we have, then, is the tax tail wagging the dog: exceptionally long leases in order to recover capital outlays on an accelerated schedule. In essence, today's tax code provides a taxpayer subsidy for these companies that far exceeds what economic reality would dictate.

And this aspect of the tax code is of interest not just because the Finance Committee must prudently shepherd our nation's tax revenues, but also because there are considerable transportation policy dangers to these very long-term leases. Chicago signed a 99-year lease for the Skyway, a road that, at the time of the lease, had only a 47-year operating history. Indiana signed a 75-year lease for its Toll Road, a highway that, at the time of the lease, had only a 49-year history. I question how, with respect to a critical artery of interstate transportation, a state can possibly predict its future needs for a period that is twice that artery's operating history. It is impossible to envision how transportation will change in the next hundred years. As a point of reference, the Model T is 100 years old this year—can we even pretend to imagine what the next century will bring? These very long lease lengths are all the more troubling because these deals often contain non-compete clauses, which make it difficult for public transportation agencies to address safety and congestion problems on highways and adjacent streets.

I, for one, think we ought to reconsider the perverse incentive that the tax code creates for such long leases—which now come at considerable expense to the nation's taxpayers. I appreciate that these infrastructure firms are merely following the letter of the law. But if depreciation rules lead to forms of investment that we judge to contravene public policy, then the Finance Committee should consider changing those rules, so that companies can write off their investments on a timeline that more closely mirrors economic reality. Indeed, public policy concerns have already led Congress to alter cost recovery periods for other assets, such as luxury cars, SUVs, and sports franchises.

Finally, I wish to state my concern with the Department of Transportation's promotion of these partnerships as the new paradigm for highway infrastructure financing. The simple fact is that for my state of New Mexico—and nearly every other state represented on this Subcommittee—the public-private partnership model is not available. New Mexico has a total of 1,000 miles of interstate, which is a little over 2% of the nation's 46,467 miles of interstate. That proportion of interstate miles is nearly three times New Mexico's proportion of the total U.S. population. Thus, our state cannot be fairly asked to bear the cost alone of maintaining interstate roads in New Mexico. But because our roads are not tolled, and are unlikely ever to be tolled, they will never be attractive to investors. I am concerned about a Federal model that promotes privatization as a panacea when that model cannot be extended on a nationwide basis.

Testimony of Linda E. Carlisle

At a Hearing of the Subcommittee on Energy, Natural Resources and Infrastructure of the Committee on Finance on "Tax and Financing Aspects of Highway Public-Private Partnerships"

July 24, 2008

Mr. Chairman, Ranking Member Bunning, and Members of the Subcommittee, my name is Linda Carlisle, and I am a partner in the law firm of White & Case LLP in Washington, D.C. I have been invited to discuss the U.S. federal income tax treatment of investments in highway public-private partnerships. I specialize in federal income taxation and advise clients with respect to the U.S. federal income tax issues that arise with respect to U.S. and foreign investments. In particular, I have provided advice regarding the federal income tax treatment of transactions involving private investments in public toll road facilities in the United States.

My testimony will discuss the general structure of private investments in public toll road facilities and the principal federal income tax issues that arise as a result of such investments.

Background

With increasing frequency in the past few years, state and local governments have sought to obtain funds for infrastructure development and maintenance from private investors rather than from tax revenues or from issues of tax-exempt bonds. These privatization transactions result from a competitive bidding process through which the most qualified and well-funded investors are awarded the right to enter into the privatization transaction. Authorization for the state or local government to enter into the final terms of the agreement typically requires approval by the state legislature and/or the legislative body of the local government.

Investments in public toll roads are attractive to private investors because toll roads may produce predictable cash flows and growth potential, provide returns on investment that have a low correlation to other asset classes (thereby providing diversification of investment risks), and may provide predictable returns over relatively long periods compared to other asset classes.

Private investments may be made with respect to existing toll roads ("brownfield projects") or may be made with respect to new toll roads ("greenfield projects").

A. "Brownfield" Toll Road Privatizations

Private investment in an existing public toll road typically takes the form of an agreement for the lease of the toll road to an entity formed by the private investors and the grant to such

entity of the right to toll the toll road for the term of the agreement, as described below.[1] These agreements are called "concession and lease agreements," and the entity formed by the private investors that enters into the concession and lease agreement with the state or local government is called the "Concessionaire."

The Concessionaire typically is a limited partnership or limited liability company that is treated for federal tax purposes as a partnership. The Concessionaire is required to make an upfront payment to the state or local government. The upfront payment to the state or local government typically will be funded with equity capital and debt from third-party lenders. The Concessionaire also may obtain debt financing in the form of loans from some of its partners or members or their affiliates.[2] Concession and lease agreements for brownfield projects may contain provisions requiring the Concessionaire to make payments to the state or local government during the term of the agreement if specified "windfall" toll revenues or refinancing gains are realized by the Concessionaire.

Under the concession and lease agreement, the Concessionaire leases the toll road for a specified term of years that generally gives the Concessionaire possession and use of the toll road for a period that exceeds the estimated remaining economic life of the real property improvements included in the toll road (e.g., between 75 and 99 years). The Concessionaire agrees to pay all costs of operating, maintaining, and repairing the existing toll road, and to return the toll road to the state or local government at the end of the lease in the condition specified in the concession and lease agreement. The Concessionaire bears all risks relating to the operation of the toll road, including risks of casualty losses, during the term of the agreement.

Tax-exempt bonds used by a state or local government to finance the construction of a toll road will retroactively cease to qualify as tax-exempt bonds if the toll road is transferred to a private company, unless the state or local government takes a remedial action specified in Treasury regulations.[3] The Concessionaire also will want the toll road and its revenues unencumbered by any debt incurred by the state or local government. Accordingly, at the inception of the concession and lease agreement, the state or local government will typically retire or legally defease any outstanding tax-exempt bonds that are secured by the toll road or the revenues from the toll road.

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1 Examples of private investments in existing public toll roads include the Chicago Skyway toll bridge (2005), the Pocahontas Parkway in Richmond, Virginia (2006), the Indiana Toll Road (2006), the Northwest Parkway in Colorado (2007), and the Pennsylvania Turnpike (2008). Similar transactions have been entered into, or are being developed, with respect to other kinds of existing public infrastructure, including the public parking facilities in Harrisburg, Pennsylvania, the public parking facilities in Chicago, Illinois, and the Chicago Midway International Airport.

2 If the Concessionaire is also required to make capital improvements to the toll road, tax-exempt private activity bond financing may be available to finance such improvements.

3 Reg. §§ 1.141-2(d)(1) and 1.141-12. All "section" references are to the U.S. Internal Revenue Code of 1986, as amended, and all "Reg. §" references are to the U.S. Treasury Regulations promulgated thereunder.

Through such brownfield projects, state and local governments are able to monetize the fair market value of a toll road in order to use the proceeds to fund other capital needs and shift the burden of operating, maintaining, and repairing the toll road during the term of the agreement to the private investors.

B. "Greenfield" Toll Road Privatizations

Private investment in a greenfield project typically takes the form of an agreement pursuant to which an entity formed by the private investors first develops and constructs the toll road in accordance with specified standards of the state or local government and then leases the completed toll road from the state or local government for a term of years typically ranging from 35 to 50 years, as described below. At the same time, the state or local government grants such entity the right to charge and collect tolls for the use of the toll road during the term of the agreement.[4] These agreements are called "development and lease agreements," and the flow-through entity formed by the private investors is called the "Developer."

The Developer is a limited partnership or limited liability company that is treated for federal tax purposes as a partnership. The Developer bears all risks relating to the construction and operation of the toll road, including risks of casualty losses, during the term of the agreement. The Developer generally is not required to make an upfront payment to the state or local government. Rather, the state or local government may be required to invest public funds in the toll road development. The state or local government also may provide tax-exempt private activity bond financing to the Developer.

As with brownfield projects, private investments in greenfield projects may contain provisions requiring the Developer to make payments to the state or local government during the term of the agreement if specified windfall toll revenues or refinancing gains are realized by the Developer.

The costs of constructing the toll road typically will be funded with equity capital and debt from third-party lenders. The Developer also may obtain debt financing in the form of loans from some of its partners or members or their affiliates and may obtain tax-exempt private activity bond financing.

Through greenfield investments, state and local governments shift the capital costs of needed additional public highway capacity to private investors and relieve the state or local government of the financial and operational risks associated with the toll road for the term of the agreement.

Federal Income Tax Treatment of Investments in Public Toll Road Facilities

The U.S. federal income tax treatment of private infrastructure investments mirrors the tax treatment of other investments in property in the United States.

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[4] Examples of private investments in new public toll roads include the Dulles Greenway in Northern Virginia (1990), the South Bay Expressway in San Diego, California (1991), and the Trans-Texas Corridor (2005).

A. Federal Income Tax Treatment of Private Investment Structure

Since the Concessionaire/Developer is generally structured as a flow-through entity, the entity itself is not subject to U.S. federal income tax. U.S. individuals and U.S. corporations that are partners or members of the Concessionaire/Developer are subject to U.S. federal income tax on their distributive shares of the income, gain, loss, or deduction from the operation of the toll road by the Concessionaire/Developer, regardless of whether the Concessionaire/Developer makes any distributions to its partners or members.

Dividend distributions by U.S. corporations that are partners or members of the Concessionaire/Developer to non-U.S. shareholders also will be subject to the 30-percent U.S. withholding tax on dividends, which may be eliminated or reduced under an applicable income tax treaty between the United States and the country in which the non-U.S. shareholder is a resident for tax purposes. In addition, non-U.S. shareholders of a U.S. corporate partner or member of the Concessionaire/Developer may be subject to U.S. federal income tax on gains from the disposition of their stock in the U.S. corporate partner or member if such U.S. corporate partner or member is treated as a "United States real property holding corporation" ("USRPHC"), as discussed below.

Non-U.S. individuals and non-U.S. corporations that are partners or members of the Concessionaire/Developer are subject to U.S. federal income tax on their share of the taxable income from the operation of the toll road by the Concessionaire/Developer because such individuals and corporations are treated as engaged in the conduct of a trade or business located within the United States. Accordingly, such individuals and corporations would be subject to U.S. federal income tax on their distributive shares of the income, gains, losses, and deductions from the operation of the toll road by the Concessionaire/Developer, regardless of whether the Concessionaire/Developer makes any distributions to such partners or members. Such non-U.S. individuals and corporations also would be subject to U.S. federal income tax on any gain or loss from the disposition of their interests in the Concessionaire/Developer.

Non-U.S. corporations that are members of the Concessionaire/Developer also would be subject to the U.S. 30-percent branch profits tax on the corporation's "dividend equivalent amount" for each taxable year. A non-U.S. corporation's dividend equivalent amount for a taxable year generally is the corporation's earnings and profits for the year that are effectively connected with the conduct of its trade or business within the United States that are withdrawn from such trade or business. Distributions by the Concessionaire/Developer to a non-U.S. corporate partner or member therefore may result in imposition of the U.S. branch profits tax, which may be eliminated or reduced under an applicable income tax treaty between the United States and the country in which the non-U.S. corporation is a resident for tax purposes.

B. Federal Income Tax Treatment of Brownfield Projects

The principal federal income tax issues relating to private investments in existing public toll road facilities are:

(1) whether the concession and lease agreement is characterized as a lease or sale of the toll road land and the real property improvements to the toll road;

(2) how the assets conveyed by the agreement should be characterized;

(3) how the amounts paid to the state or local government at the inception of the agreement should be treated; and

(4) whether a U.S. corporate partner or member of the Concessionaire/Developer will be treated as a U.S. real property holding corporation for purposes of the rules regarding foreign investments in U.S. real property ("FIRPTA").

1. Lease Versus Sale Treatment

Whether an agreement, which in form is a lease, is in substance a sales contract depends on whether the benefits and burdens of ownership of the subject property have been transferred.[5] In making this determination, the Internal Revenue Service and the courts have looked to the substantive rights and economic interests of the parties, notwithstanding the legal form of the transaction at issue.[6] Some of the factors that have been considered by the courts in making this determination are: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.[7] None of these factors is necessarily controlling, and the incidence of ownership depends upon all the facts and circumstances of the particular case.[8]

If the agreement conveys possession of the property to the taxpayer for substantially all of the remaining economic life of the property in exchange for a lump-sum payment that approximates the price for which the property could be purchased, the agreement should be treated for federal income tax purposes as a transfer of beneficial ownership of the property even though the agreement prohibits the transfer of legal title to the taxpayer.[9]

The typical concession and lease agreement conveys possession and control of the toll road to the Concessionaire for a period of years that is in excess of the remaining economic life

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5 See Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981).

6 See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) (substance, not form, of lease transaction controls for U.S. federal income tax purposes). See also Weiss v. Weiner, 279 U.S. 333 (1929) (depreciation allowed where taxpayer has made investment in depreciable property, whether as lessee or owner); City National Bank Co. v. Helvering, 98 F.2d 216 (D.C. Cir. 1938) (depreciation allowed lessee only where lessee has invested capital in property).

7 Grodt & McKay Realty, Inc. v. Comm'r; Coleman v. Comm'r, T.C. Memo. 1987-195, aff'd, 16 F.3d 821 (7th Cir. 1994).

8 Int'l Paper Co. v. U.S., 33 Fed. Cl. 384, 393-94 (1995); Baird v. Comm'r, 68 T.C. 115, 124 (1977).

9 Rev. Rul. 55-541, 1955-2 C.B. 19.

of the real property improvements included in the toll road, such as roads, bridges, sidewalks, drainage facilities, fences, sewers, landscaping, buildings, parking lots, and toll plazas, even though legal title to such improvements remains with the state or local government. During the term of the agreement, the Concessionaire bears the risk of loss or damage with respect to the real property improvements to the toll road. The upfront payment by the Concessionaire will exceed the fair market value of the real property improvements located on the land leased to the Concessionaire. Under these circumstances, the Concessionaire should be treated for federal income tax purposes as having acquired, rather than leased, the real property improvements.

In contrast, land is deemed for tax purposes to have a perpetual useful life. Accordingly, the lease of the land on which the toll road is located should be treated for tax purposes as a lease of the land.

2. Characterization of Assets Conveyed by the Agreement

In addition to acquiring ownership of the real property improvements, the Concessionaire has: (1) leased the land on which the toll road is located; (2) acquired ownership of any tangible personal property conveyed to the Concessionaire as part of the toll road; (3) acquired any goodwill or going concern value associated with the toll road; and (4) been granted the right to charge and collect tolls.

Government licenses, permits, and franchises that are not "interests in land" are amortizable section 197 intangibles that are amortized over a 15-year period. Interests in land include fee interests, life estates, remainders, easements, mineral rights, timber rights, grazing rights, air rights, zoning variances, and similar rights.[10]

There is no authority directly addressing whether a right to charge and collect tolls for the use of a public highway is an interest in land for purposes of section 197. In many states, private persons are prohibited from operating toll roads or charging tolls without the express authorization of the state. In such states, the right to charge tolls for the use of a public highway located on land owned or leased by a private person requires the express authorization of the state. In such states, the license or franchise to toll a toll road should not be treated as an interest in land because it is not a right that inheres in the fee simple interest or lessee interest in land. Accordingly, in such states the right to charge and collect tolls for the use of public highway should be treated as a section 197 intangible that is amortizable over a 15-year period. If the franchise to charge and collect tolls is not treated as a section 197 intangible, the franchise should be amortized on a straight-line basis over the term of the concession and lease agreement.

3. Treatment of the Upfront Payment

a. Prepaid Rent

Prepaid expenses, including prepaid rent, must be capitalized. The portion of the upfront payment made by a Concessionaire that is allocable to the lease of land therefore generally would be required to be capitalized and deducted ratably over the term of the agreement.

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[10] Reg. § 1.197-2(c)(3).

Section 467 and the regulations thereunder, however, provide special rules for payments made pursuant to "section 467 rental agreements." Reg. § 1.467-1(c)(1) defines the term "section 467 rental agreement" as a rental agreement that either has "increasing or decreasing rents" or has "deferred or prepaid rents." Accordingly, a rental agreement that provides for a single lump-sum payment at the inception of the lease has decreasing rents and is a section 467 rental agreement. Reg. § 1.467-1(d)(2)(i) prescribes a "constant rental accrual" method for section 467 rental agreements that are "disqualified long-term agreements." A rental agreement is "disqualified" if a principal purpose for increasing or decreasing rents is tax avoidance.

It is not clear that section 467 would apply to the prepayment of rent under a concession and lease agreement. However, if section 467 is applicable, the prepayment of rent would be treated as a loan by the Concessionaire to the state or local government and the Concessionaire would be required to recognize interest income on the deemed repayment of the deemed loan over the term of the agreement. The Concessionaire also would be treated as making level annual rental payments equal to the level loan payments it is deemed to receive.

b. Costs of Acquiring Intangible Assets and Real Property Improvements

Because the toll roads acquired under concession and lease agreements constitute trades or businesses, the upfront payment made to the state or local government is required to be allocated among the assets acquired by the Concessionaire under the so-called "residual method."[11] Under the residual method, the upfront payment by the Concessionaire is allocated to the leasehold interest in the land, the real property improvements to the land, and any tangible personal property conveyed to the Concessionaire as part of the toll road, to the extent of the fair market values of those assets. To the extent the upfront payment exceeds the fair market value of such assets, the excess is allocated to any section 197 intangibles acquired by the Concessionaire, other than goodwill or going concern value, to the extent of the fair market values of such intangibles. Any remaining amount of the upfront payment is allocated to goodwill or going concern value.

The Concessionaire should be allowed to amortize its investment in any intangible property that it acquires under the concession and lease agreement. As discussed above, the right to charge and collect tolls for the use of the toll road in most states should be treated as an amortizable section 197 intangible, which is amortizable over a 15-year period beginning with the month in which such right was acquired. Any goodwill or going concern value acquired by the Concessionaire also would be treated as amortizable section 197 intangibles.

The Concessionaire also should be allowed to depreciate the real property improvements acquired and any other tangible personal property conveyed to the Concessionaire. Tangible depreciable property is generally depreciable under the Modified Accelerated Cost Recovery System ("MACRS"), which generally provides for accelerated depreciation over recovery periods specified in section 168. Nonresidential buildings and their structural components, however, are depreciated on a straight-line basis under MACRS.

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[11] Section 1060.

In brownfield projects, the original construction of the existing toll road and improvements to the toll road have generally been financed with the proceeds of tax-exempt state or local bonds. As discussed above, the state or local government typically retires or legally defeases those bonds when it enters into the concession and lease agreement. MACRS depreciation is not allowed for "tax-exempt bond financed property," which must be depreciated using the straight-line method over alternative recovery periods specified in section 168.[12] The term "tax-exempt bond financed property" is defined as property financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103 (relating to interest on state and local bonds).[13]

It is unclear whether property financed by a state or local government with the proceeds from tax-exempt bonds is treated as tax-exempt bond financed property when such property is transferred to a taxable entity and such tax-exempt bonds are retired or legally defeased. Accordingly, to the extent that toll road property was ever financed with the proceeds of tax-exempt bonds, such property may be ineligible for MACRS depreciation in the hands of the Concessionaire, regardless of whether the state or local government retires or legally defeases such tax-exempt bonds when it enters into the concession and lease agreement.

4. Possible FIRPTA Issues

A non-U.S. corporation or non-resident alien individual that is a shareholder in a U.S. corporation that is a partner or member of the Concessionaire/Developer is not treated as engaged in the conduct of a U.S. trade or business and is not subject to U.S. federal income tax on income from the operation of the toll road. Rather, as discussed above, the U.S. corporate partner or member of the Concessionaire/Developer is subject to U.S. federal income tax on its distributive share of the income, gain, loss, or deduction from the Concessionaire/Developer's operation of the toll road and dividend distributions to non-U.S. shareholders are subject to the U.S. 30-percent withholding tax, which may be reduced or eliminated under an applicable income tax treaty.

Non-U.S. corporations and non-resident alien individuals who are not engaged in the conduct of a U.S. trade or business generally are not subject to U.S. federal income tax on gains from the sale or exchange of property. Under section 897, however, non-U.S. shareholders of a U.S. corporate partner or member of the Concessionaire/Developer will be subject to U.S. federal income tax on gain from the sale or disposition of stock in such U.S. corporation (or distributions from such U.S. corporation that are treated as amounts paid in exchange for stock of the U.S. corporation) if such U.S. corporation is a USRPHC.

A U.S. corporation is a USRPHC if 50 percent or more of the fair market value of its assets is attributable to U.S. real property interests ("USRPIs"). For this purpose, a corporation is treated as owning its share of assets held by a partnership in which it is a partner. USRPIs include interests in land and real property improvements such as structures, buildings, roads, bridges, and parking lots. The leasehold interest in the land on which a toll road is located and the real property improvements located on such land should be treated as USRPIs. Tangible

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12 Section 168(g)(1).

13 Section 168(g)(5).

personal property and goodwill or going concern value are not treated as interests in real property.

There is no guidance that directly addresses whether a license or franchise to charge and collect tolls for the use of a toll road constitutes an interest in real property for purposes of section 897. In those states in which private persons are prohibited from operating toll roads or charging tolls without the express authorization of the state, fee simple ownership of land or a leasehold interest in land does not give the owner or lessee of the land the right to charge tolls for the use of a public highway located on such land. In such states, the license or franchise to toll a toll road should not be treated as an interest in real property because it is not a right that inheres in the fee simple interest or leasehold interest in land. Accordingly, for purposes of determining whether the fair market value of USRPIs held by a U.S. corporate partner or member of the Concessionaire/Developer is 50 percent or more of the fair market values of all assets held by such U.S. corporation, the fair market value of the right to charge and collect tolls in such states should not be treated as the fair market value of a USRPI.

C. Federal Income Tax Treatment of Greenfield Projects

The principal federal income tax issues that relate specifically to private investments in greenfield projects are:

(1) how the public funds provided by the state or local government for construction of the toll road should be treated; and

(2) whether the amounts paid by the Developer for real property improvements are rent.

1. Treatment of Public Funds

In a greenfield project, the state or local government may agree to provide a specified amount of funds to pay for a portion of the costs of constructing the toll road. The Developer pays for all of the other costs of constructing the toll road. When construction of the toll road is completed, the Developer leases the toll road built with both public and private funds from the state or local government.

In the typical development and lease agreement, the Developer is not given funds by the state and local government without restrictions. The funds provided by the state or local government must be used to pay or reimburse costs of constructing the toll road. In a typical development and lease agreement, the economic usefulness of the real property improvements paid for with public funds will not expire at the end of the agreement, and such property will revert to the state or local government at the termination of the lease. Thus, the state or local government is the ultimate beneficiary from the use of the funds it provides. In addition, the Developer is not required to repay any of the public funds amount, even if the Developer terminates the development and lease agreement before the end of its term. Under these circumstances, the amount of funds that a state or local government provides to pay for a portion of the construction costs of the toll road should not constitute gross income of the Developer and should not be included in the Developer's depreciable basis for the improvements to the toll

road. Rather such public funds should be treated as funding leasehold improvements paid for by the state or local government.

2. Construction Payments Made by the Developer

Development and lease agreements for greenfield toll roads typically do not provide that any portion of the improvements constructed by the Developer are intended to be treated as rent. Unless a tenant's construction of improvements on leased property are intended by the parties to be treated as rent, the tenant's expenditures to construct such improvements should be capitalized and recovered by the tenant through allowances for depreciation.[14] Therefore, the Developer should be allowed to claim depreciation deductions with respect to its capitalized costs of constructing leasehold improvements to the toll road. As discussed above, such capitalized costs would not include any public funds amount and the Developer would not be allowed to claim depreciation deductions with respect to leasehold improvements paid for with funds provided by the state or local government.

Conclusion

The upfront payment made to a state or local government in a brownfield project is in exchange for the transfer of: (i) the tax ownership of real property improvements to the existing toll road; (ii) a lease of the land on which the real property improvements are located; (iii) a government franchise to charge and collect tolls; and (iv) any goodwill or going concern value in the brownfield project. The cost of such assets may be depreciated or amortized for tax purposes. A U.S. or non-U.S. investor in such a project is engaged in the business of operating the toll road and pays tax on income earned from the project. The U.S. branch profits tax and FIRPTA withholding tax also may apply.

These are the same results that would apply to any acquisition of a U.S. business. Accordingly, there are no unique rules that enhance the tax benefits of brownfield transactions. To the contrary, because most brownfield projects have been financed with tax-exempt bonds, private investors in a brownfield project may receive less tax benefits through depreciation deductions than would an investor in a private business.

Similarly, greenfield investments result in depreciation only with respect to amounts paid as leasehold improvements by the Concessionaire. No extra deductions are provided. It is possible, however, that tax-exempt bond financing can be used, but this is not a special result for greenfield projects. Moreover, non-U.S. investors are also subject to tax as they would be in any U.S. investment.

In summary, public-private infrastructure investments provide needed infrastructure for state and local governments with no extraordinary tax benefits to the private parties. I would be pleased to respond to any questions.

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[14] Section 263(a); section 263A; Reg. § 1.167(a)-4; section 168(i)(8).

Testimony
Of
Pat Choate

Subcommittee on
Energy, Natural Resources, and Infrastructure
U.S. Senate Committee on Finance

Hearing on the Tax and Financing
Aspects of Highway Public-Private Partnerships
215 Dirksen Senate Office Building

July 24, 2008

Mr. Chairman and Members of the Committee:

Thank you for the invitation to be with you today. I was asked to provide a brief overview of the state of our national infrastructure and the growing role of the private sector in the financing and operation of our national highway infrastructure. While these comments are generally about highways, most are equally applicable to America's other domestic civil works.

Declining National Effort

The infrastructure – that is, the domestic civil works such as roads, bridges, water systems, levees and wastewater treatment facilities -- of the United States is decaying faster than it is being built, replaced, repaired and maintained. It is inadequate for today's needs, let alone tomorrow's. This is a direct consequence of a declining public effort relative to both our needs and our fiscal capacity. The arithmetic of this diminishing public effort is documented in the attached Table 1.

While in the 1960s, the U.S. public sector devoted almost 5.3 percent of its Gross Domestic Product (GDP) to fixed capital investments (domestic plus national security); the level of effort has declined steadily over the intervening five decades.

When defense expenditures are removed from these calculations and consumption of that fixed public capital (depreciation) is factored into the equation (producing the net investment), we can see that such expenditures fell from 2 percent of the GDP in 1960 to 1.14 percent in 2006, a decline of 43 percent. If this declining effort continues, we will have fewer public facilities, producing lower levels of service, at the end of the next decade than we do today.

Table 1

Government Investment in Fixed Capital
(1960-2006)

	1960	1970	1980	1990	2000	2006
GDP (billions $)	526	1,038	2,789	5,803	9,817	13,914
U.S. Population (millions)	180	205	227	249	281	300
Gross Govt. Investment (billions $)	28.3	43.6	100.3	215.7	304.5	433.8
Gross Investment as percent of GDP	5.3%	4.2%	3.6%	3.7%	3.1%	3.1%
Net Investment Less Consumption (billions $) (All units of Govt. minus defense)	10.7	19.5	37.5	71.3	119.0	158.8
Net Domestic Investment as percent of GDP	2.0%	1.87%	1.34%	1.22%	1.21%	1.14%

Source: Population estimates are from the U.S. Census Bureau. Government investment data is from "Table 5.2.5 Gross and Net Domestic Investment by Major Type, National Income and Product Accounts, Bureau of Economic Analysis, (July 2008). Consumption of fixed capital are estimates by the BEA. Per capital calculations are by the author.

As this table also documents, the U.S. population expanded by more than 120 million people in the same period – a growth of 66 percent.

The fact is the U.S. population increased by two-thirds since 1960 and our net relative effort, as a part of the GDP, decreased by more than 40 percent.

In major part, highway financing has not kept pace with demands for investment because the fuel taxes have not been indexed for inflation. If they were, the current 18.3 cents per gallon devoted to the Highway Trust Fund would be 27 cents. A 9-cent increase in the price of $4 gasoline does not seem much of a burden.

The importance of not indexing for inflation is found in what happened between 1993, the last time Congress adjusted those taxes, and today. What $1,000 bought in 1993 now costs $1,460 because of inflation. Put another way, what government could buy for $1,000 in 1993 now only gets $703 of goods.

As we look to the next 50 years, the Federal Highway Administration projects that the highway vehicle miles of travel will increase from 3 to 7 trillion, a 133 percent increase.

The nation's other public capital will face similar demands. The U.S. Census Bureau, for example, reports that the U.S. population will increase to 419 million by 2050 from its present 303 million.

Yet, the nation is unprepared to meet the demand placed on our public infrastructure. Most significantly, the U.S. lacks a long-term strategy for such public investment, especially as articulated in a national capital budget. A systematic and orderly approach to public capital investment by the federal government would provide the context for state and local investments. Because the national government makes roughly 40 percent of the overall public infrastructure investments, chaos at the federal level is automatically transferred to state and local decision makers.

How can one rationally explain this steadily diminishing effort in the face of a growing population and obvious national needs?

I conclude that three factors are at play, which in combination are creating the almost perfect storm that brings us to this hearing.

(1) Anti-Government Ideology

In the middle of this four-decade plus era since 1960, the prevailing governing ethos became "The government is the problem, not the solution." The implied assumption is the private sector can virtually always perform work better than the public sector can. For more than a decade, the presumption has been transformed into the massive outsourcing of public activities to the private sector. This privatization is increasing in the building and operation of our public infrastructure, notably highways.

The issue is not whether the administrators, engineers, accountants, lawyers and others working in the U.S. Department of Transportation and in the State and local highway departments are generally less skilled, competent, productive and efficient than their private counterparts. They are not.

Indeed, other nations come to the United States to learn from these public servants.

Moreover, the United States has put into place over many decades various oversight mechanisms that generally ensure that such work done by the public sector is free from massive corruption, waste and gouging of the public. The recent experiences of the U.S. in its extensive use of private contractors to provide defense infrastructure both here and abroad are just the opposite.

Rather, the real issue, often coyly stated, is not about the competence of our transportation agencies; it is about the political courage of our elected officials; they are afraid to ask voters to pay for what the public wants and needs. In searching various studies for this testimony, I was struck by how many times the argument is made that a private corporation, shielded from real public oversight, can make the tough decisions and raise the transport taxes that elected officials would never consider.

(2) The Politics of Taxes

In major part, those political fears are very real. Our contemporary politics are dominated by an aversion to the pay-as-you-go principles that long guided U.S. fiscal policies. In part, this is an extension of the anti-government ideology. I have some personal knowledge of how this works. In 1984, the Reagan Administration invited me to serve on a small Commission that was charged with devising domestic policy recommendations for the President's second term. The work became entangled in whether to adopt a "starve the beast" strategy advocated by several fellow commissioners. They wanted to borrow and spend massively and by that expand the national debt and deplete the government's capacity to borrow to the point that future Presidents and Congress would be forced to cut or privatize programs such as Social Security and Medicare, which they strongly opposed.

That strategy, though seldom stated as such, was reversed in the 1990s by the end of which time the federal government was operating at a surplus, actually paying down the debt. I think history will judge this to be President Clinton's single greatest policy and political achievement.

In this decade, however, "no new taxes" and "cut the taxes" are the political mantras, even as national borrowing, increasingly from the central banks of China, Japan, South Korea and Taiwan, has raised the national debt from $5.7 billion at the end of 2000 to more than $9.5 billion today. Whether by design or accident, we have returned to a "starve the beast" policy.

These deficits and the inability of our government to finance and operate domestic civil facilities are no accident. The power of no new tax politics is found in the vast number of public figures who have signed and posted on the Internet a solemn "no tax pledge." As of May 2008, that list included President Bush, 192 U.S. Representatives and 41 U.S. Senators. Moreover, the list includes 240 challengers for House seats in the 2008 election, as well as 32 U.S. Senate challengers.

No similar concern is exhibited for deficit spending.

Significantly, "no tax" politics extend deeply into state governments, which provide up to 60 percent of all U.S. infrastructure investments. As of April 2008, 1219 incumbent state legislators had taken the "no tax pledge," as had 8 Governors, 7 Lt. Governors, 3 Attorneys General, 3 Secretaries of State, 3 Treasurers, and 1 Controller. An equally large list of challengers for state office has also made and posted similar pledges.

(3) Vested Interests

Beyond ideology, the privatization of here-to-fore public functions has many direct beneficiaries. Investment banks, wealthy private investors, specialized law firms, contractors, engineers, and speculators all seem to do very well – at least as measured by some of the Public-Private Partnerships that have already been put into place.

As the principal corporations from Europe and Australia who lead many such projects note on their web sites, these types of investments are highly profitable. One billionaire tells me that he is being offered 18 percent returns for such investments.

Such privatization gives the corporate operators enormous control over the setting of transport taxes (tolls). These contracts often have no-compete provisions that require the state or local government to compensate them for any improvements on public roads that drive traffic away from the toll road. Indeed, as traffic seeks alternative routes and diminishes service on free roads, the pressure to use the toll way intensifies.

Ironically, one of the principal vested interests are the state and local officials who impose increased transport taxes, via private corporations, onto their citizens. The State of Indiana, for instance, sold the operation of the Indiana Toll Road to an Australian/Spanish consortium for $3.85 billion. This allows the Governor to keep his no new tax pledge, earn $500,000 per day in interest

for the state, distribute $250 million to the counties surrounding the toll road, and fund dozens of other projects throughout the state.

As part of the deal, the Governor agreed to double the tolls before turning over control. The private corporation will be able to raise the tolls after 2010 at a rate greater than 2 percent of an amount equal to an increase in the consumer price index or the nominal gross domestic product per capital growth. The tolls are likely to rise by at least 4 percent annually and much more if inflation increases.

Because the lease is for more than 55 years, the IRS will treat the consortium as the owners, allowing them to depreciate their investment at an accelerated rate over 15 years. This is worth several hundred million dollars. If at the end of 15 years, the lease is sold, the profits will be taxed at a low capital gains rate and the new owners can begin the depreciation process over for another 15 years. I look forward to testimony by fellow panelists today as to the costs of these arrangements to U.S. taxpayers.

In Chicago, the sale of the Skyway lease for 99 years for $1.82 billion provided monies to a city government that was in deficit by $200 million. Those monies have been used for many purposes, many of which are non-transport related.

In Texas, their PPP arrangements have been structured in a way to provide both upfront monies to the state for the long-term lease of public highways and the construction of new roads, plus a percent of the revenues. The Texas Governor is already financing much of state government through transport taxes and he intends to increase that source of revenue. Between the mid-1990s and today, some $15 billion has been diverted from the Texas Department of Transportation to the general fund where the monies are used to finance education and other programs. Simply put, Texas is not financing needed road investments because it is using its highway monies to finance non-transport functions.

In 2007, the Governor of Texas went a step further; He announced that Texas would not construct any new roads unless they were tolled. He also asked the President and Congress to allow Texas to reimburse the federal government for the monies it had invested in federal interstate roads in Texas. Texas could then lease its portion of the Interstate Highways to private operators for 50 years or more, collect the upfront concession fees and receive part of the revenues. The Texas PPP is as much about financing state government through transport taxes as it is about providing good transportation.

Looking Forward

Attached is a Federal Highway Administration projection of U.S. highway congestion by the year 2020. If the present pro-transport tax policy of the U.S. Government is continued, it is also likely to be a map of future toll roads in the United States.

Governors and mayors are under extreme pressures to maintain even present levels of transport services. Thus, imposing a transport tax by outsourcing the political risk to a private corporation, which is often located in Australia or Europe, is increasingly attractive.

The U.S. Department of Transportation is aggressively pushing the use of transport taxes imposed and administered by such private corporations. The Department has prepared a detailed legal analysis for each state as to what changes in its constitution and state laws are required to undertake these projects. And it offers low cost loans and tax-free bonds for financing these deals. Such projects are now on the planning boards in 25 states.

Various studies estimate that about 20 percent of the nation's future highway needs can be financed through private arrangements, of which there are many variants. Most of those are in areas with high-volume congestion, such as the I-495 Hot Lanes deal the State of Virginia has made with a private corporation but 80 percent financed with Federal and State monies.

When the Interstate System was first conceived in the late 1930s, a fundamental question was whether to build the system as freeways or toll ways. President Roosevelt's advisors concluded after much study that the nation was so vast and that in many areas the traffic would be so light that transport taxes would be insufficient to build a true national system. What would emerge is a hodge-podge of good roads in some areas and bad or no roads in others.

As the congestion map also reveals, about 80 percent of the roads in the National Highway System are probably too unattractive for a transport tax approach today or in the foreseeable future. Inevitably, those states with large stretches of such roads will be shortchanged under existing policies.

The policy behind U.S. highway construction during the Eisenhower era was to build a truly national system that would provide unimpeded transport to all parts of the nation at the lowest possible cost to users. The market pricing approach now being advocated would limit transport to those able to pay. It would seek to maximize revenues on toll roads, even if that meant forcing traffic to side roads.

Conclusion

The present transport policies of the Government of the United States will put into private hands control of key parts of our national highway infrastructure for a half century or longer. It will significantly raise the costs of transport over what it is now and, more important, what it could be if the public sector followed the pay-as-you go public approach devised by the Eisenhower Administration and championed in the Congress by Senator Prescott Bush of Connecticut.

While many argue that tolling of existing or new roads is really a matter for state and local governments to decide, the whole of the nation has a direct interest because all taxpayers are involved when their national government finances many of these projects and when all taxpayers are required to make-up the costs of 15 year accelerated depreciation on these projects.

Several recent studies from the GAO on this subject are particularly informative about key policy questions involved with privately administered transport taxes. Having examined several of these PPP deals, notably those in Texas and Indiana, I strongly agree with the GAO that much stronger analysis is required on the economic and social impacts before these deals are made. Governors and mayors are swayed by the prospect of upfront cash they can use, while leaving any problems in the deals to their successors.

While the private corporations surely have a strong analysis of the fundamentals of those deals, the voting public does not. Notably, the Texas and Indiana projects were done with much secrecy, the corporate and Wall Street lobbyists were involved inappropriately, and the details of the deals given the public were often false.

I am also concerned that the U.S. Department of Transportation so strongly favors the wider use of privately administered transport taxes that other alternatives are not being adequately considered. The public would benefit from an independent, third party economic analysis of these new policies v. the traditional pay-we-go approach long used in the United States. A beginning premise should be there are public officials who are unafraid to ask voters to pay for what they want done.

Finally, our future demands for infrastructure investment are so great that a coherent federal approach is required as embodied in a national capital budget. Indeed, it is long overdue.

Thank you.

Testimony
Of
Dennis J. Enright
Before
United States Senate
Subcommittee on Energy, Natural Resources and Infrastructure
July 24, 2008

Infrastructure Financing Issues in the United States

Over the past 2 years, ever since the Chicago Skyway Public Private Partnership("P3") 99 year lease transaction, there has been much discussion and debate on the need and or value of having private operators take over the long term ownership, financing and operating obligations of US infrastructure assets which to date have been the responsibility of public bodies.

Most of the focus on utilizing the private sector has been to tout 2 advantages:

- Availability of investment capital
- Infrastructure management that is more focused on profitability

In my view these 2 alleged advantages have been promoted without a thorough review of the impact upon the general public that utilizes infrastructure assets and in the end must pay for them through some form of user fees.

Additionally it is important to note that there is no shortage of investment capital available to fund public sector owned and operated infrastructure. Secondly, with rare exception, most publically owned and operated infrastructure is run just as efficiently as any private operator could. Any cases of higher operating costs is almost always directly

related to the higher costs of fringe benefits in the public sector for health care insurance and pensions, rather than any lack of operating talent.

An often misused measure of both private investment interest in infrastructure investment and public sector lack of efficiency is EBITDA ("Earnings Before Interest, Taxes, Depreciation and Amortization") or pure cash flow from operations. Publicly owned and operated infrastructure has little positive cash flow because their **public mission** is to provide **affordable services** to its customer base, as a result when infrastructure has been sold to private interests these sales have been hailed as successful because they were purchased at very high multiples to EBITDA, perhaps 20 to 30 times EBITDA, when typical private to private sales would be at 10 to 15 times EBITDA. Thus giving the impression that the private sector can run the assets more efficiently and therefore is willing to pay a higher price. In reality the price is not established in relationship to *historical* EBITDA but is based upon *projected* future EBITDA which is largely driven by the massive increases in rates allowed in the P3 model. As an example, if the toll rates granted to the private buyers of the Chicago Skyway were applied retroactively to the Holland Tunnel from its opening in 1929 the toll at the tunnel today could be $185 rather than the $8 it is today.

Another misconception is created by promoters of privatization creating new metrics that support their case. The presentation of these new measures often sounds compelling but upon review they are often revealed as "voodoo economics". Recently in the battle over leasing the Pennsylvania Turnpike one advocate for privatization used the metric of operating expenses as a percentage of revenues as a measure to prove alleged inefficiency of operations. In reality this is a bogus measure since the lowest toll rates possible goal of a public authority drives a de facto result that their debt and operating expenses consume almost all of their revenues. In fact the Pennsylvania Turnpike maintains one of the 3 lowest tolls per mile in the country at about 5 cents and therefore its expense will reflect a higher percentage of revenues. This would not be true in the hands of a private operator who must increase tolls to squeeze out a profit margin. The true measure of efficiency is

operating cost per mile of toll road and the Pennsylvania Turnpike would score well for efficiency using this metric.

Private Infrastructure in the United States

The utilization of the private sector to provide infrastructure in the US has deep roots that go back to the 18th century when private toll roads were common. Today although there is still much private infrastructure it is largely focused on areas where the private sector has taken technology and market acceptance risk. The infrastructure involved can be divided into 2 distinct classes of assets:

1- Regulated Utilities
   a. Electric
   b. Water and wastewater
   c. Telephone
   d. Cable
   e. Natural gas

2- Risk Transfer Assets
   a. Solid Waste
   b. Health care

In both categories the public sector and the end users were protected either through pricing regulation or through elimination of risk. The history of private ownership was largely due to an undeveloped public ownership model and also the need to install the infrastructure across multi jurisdictional boundaries at a time when regional entities were not a commonplace solution. In the case of some of the oldest forms of private infrastructure assets like electricity and telephone, there was also uncertainty about how successful these new technologies would be since the public needed to pay for them, much like many of us said we would never pay for TV since we could get it for free over the airwaves. These types of technology and business risks are appropriate for the private

sector to lead, however the public sector has always looked to pricing and open access regulation as a method to protect the public. One only need look at the deregulation of the electric markets in California in the past decade for an example of why utility regulation is appropriate.

This rich history of private enterprise providing infrastructure assets to serve the public continues today largely because that is how it was first established and because it is working in a price and quality controlled manner that is overseen by public officials whose interests are to protect the consumer.

However, much of the current focus of the P3 debate is addressing the transfer of existing publicly owned assets to the private sector. These public infrastructure assets, including roads, water, wastewater and port facilities have been largely owned and operated by the public sector and been sensitive to both the pricing needs and the service needs of the public. Public sector management is largely composed of highly competent career civil servants with no profit motivated agenda. This lack of profit motivation has been often cited as a negative, but most people do not understand that profit must be included in the cost of privately owned infrastructure and paid for by the consumer. Public infrastructure providers such as water and toll road systems only need increase prices to pay for ongoing capital needs not to increase returns to investors. Additionally in the US publically owned infrastructure is eligible to raise its capital in the tax exempt bond market which produces a cost of capital 30% lower than a private sector provider. Since these are capital intensive industries the cost of capital is a prime mover in determining the cost of service charged to the consumer, whether it is water usage rates or road tolls.

Financing

Infrastructure finance is not very different than real estate finance, which most people understand to some degree. In real estate finance an income producing property becomes the collateral for a loan and the rents that are charged are set at a level sufficient to be sure the owner can pay the loan and the operating costs and make a profit. The higher the

interest rate on the loan and the higher the return on equity to the owner then the higher the rents will rise in order to pay for the cost of capital. Infrastructure is not very different, the cost of installing and operating a water plant, sewer lines or roads will need to be recovered from the rates, charges and tolls that users of the infrastructure will pay. Once again the higher the cost of capital the higher the user charges will be.

The Role of Leverage

Many proponents of private investment in infrastructure are of the opinion that the use of private equity, rather than debt capital, will reduce the cost of capital. This is a fallacy. Equity capital is the most expensive source of investment capital and commands returns of 10 to 20% or even more in the case of venture capital. Asset based investments by definition are fixed in placed and not movable, therefore the investor cannot expect to obtain increased returns from synergies or new marketing strategies for products to the public. The equity investor is also sacrificing liquidity when fixed asset investments are chosen. They cannot easily be traded like stocks on the stock exchange. It takes time and costs money to dispose of fixed assets. As a result investors expect to be compensated for this lack of liquidity and command higher equity return hurdles. It is true they may be willing to wait for these returns to accumulate over time rather than achieve their return rates today, however, this just means that they are imposing that accrual on the projected cash flows from the assets itself. There is no free lunch. The high cost of equity capital is the reason leverage is employed in the private ownership of infrastructure assets.

Leverage is the borrowing of debt capital and combining it with equity capital to achieve a lower overall cost of capital (often referred to as the Weighted Average Cost of Capital or WACC). This combining of equity and debt capital is not done in the public ownership model where an all debt capital structure is utilized. The benefit of leverage is that the more debt that is utilized the lower the overall cost of capital. A few years ago an 80% debt /20% equity structure was typical, however, today with the credit markets in distress that model has change to a 60% debt/ 40% equity formula as shown by the bids for the Pennsylvania Turnpike. This lower leverage increased the cost of capital to over 9% from

an expected rate range of 7-8%. This resulted in lower than expected bids from private investors. It is important to note that a public authority could access the capital markets at rates near 5% for the same transaction.

The lower the cost of capital the higher the valuation of the asset up for sale. Our past analyses have shown that a public sector funding model would produce a value at least 30% greater than a private ownership model or could produce the same valuation with 30% lower user charges.

The following chart illustrates how leverage impacts the cost of capital for a transaction:

Impact of Leverage on the Cost of Capital
Private Concession Deal

Rates= Debt at 10 year US Treasury plus 3.50%
Equity at 10 year US Treasury plus 7.00%
10 year US Treasury = 4.03%

Debt Funding Percentage	Equity Funding Percentage 0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
100%	7.53%										
90%		7.88%									
80%			8.23%								
70%				8.58%							
60%					8.93%						
50%						9.28%					
40%							9.63%				
30%								9.98%			
20%									10.33%		
10%										10.68%	
0%											11.03%

= Likely Range of Funding Cost

Responses to Questions for the Record From Dennis Enright
Subcommittee on Energy, Natural Resources, and Infrastructure
Committee on Finance
Hearing of July 24, 2008
Tax and Financing Aspects of Highway Public-Private Partnerships

Questions From Senator Bingaman

1. *Some have suggested that states can more cheaply finance road infrastructure than private companies. Can you explain why this is the case?*

   Governmental bodies, whether they be states, cities or toll road authorities, have direct access to issuance of bonds for public projects, the interest on which is exempt from federal and state taxation. As a result, the interest rates on these bonds are typically 30% to 40% lower than the costs of capital for a private entity financing the exact same road project. In a private deal there is a need to raise between 20% and 40% of the cost in equity capital. Equity capital is the most expensive form of capital and drives up the overall cost of funds. Thus, if a private deal were to have a weighted average cost of funds of 9% between debt and equity, then a public project would have a cost of funds of less than 6%. This lower cost of funds, due to the capital-intensive nature of road projects, translates into a 30% lower cost to users of the road if done with public sector financing.

2. *If states can more cheaply finance road infrastructure, does the mere involvement of the private sector translate into highway users paying higher tolls under a concession agreement, as compared to state-owned toll roads?*

   The answer is generally yes, as pointed out above. Private road owners want equity returns of 10% and above. There are some operating savings that can be achieved with private operators, but nowhere near enough to offset the higher costs of capital.

3. *Under the Chicago and Indiana deals, will states be liable for costs if the concessionaires go bankrupt?*

   In the Chicago and Indiana deals neither the city of Chicago nor the state of Indiana have direct liability for costs if the road concessionaires go bankrupt. However, a bankruptcy will not return the roads to the public since the lenders have been pledged the concession and will seize the assets and hire a new operator. The city or state will have say over this but not veto power. As long as the new operator complies with the concession agreement, the private deal continues. Since lenders are not in the business of operating toll roads, it is likely they will seek a "bailout" by trying to sell the roads back to the government. This has happened in Mexico and other spots around the world and recently in Texas for a road near the Mexican border. Texas was able to buy it back at a large discount to the actual cost of the road. The price of the asset will be directly related to its performance financially.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Energy, Natural Resources, and Infrastructure, Committee on Finance, U.S. Senate

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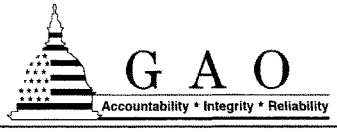
HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS

Securing Potential Benefits and Protecting the Public Interest Could Result from More Rigorous Up-front Analysis

Statement of JayEtta Z. Hecker, Director
Physical Infrastructure Issues



GAO-08-1052T

July 24, 2008

GAO
Accountability · Integrity · Reliability
Highlights

Highlights of GAO-08-1052T, a testimony before the Subcommittee on Energy, Natural Resources, and Infrastructure, Committee on Finance, U.S. Senate

HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS

Securing Potential Benefits and Protecting the Public Interest Could Result from More Rigorous Up-front Analysis

Why GAO Did This Study

The private sector is increasingly involved in financing and operating highway facilities under long-term concession agreements. In some cases, this involves new facilities; in other cases, firms operate and maintain an existing facility for a period of time in exchange for an up-front payment to the public sector and the right to collect tolls over the term of the agreement. In February 2008 GAO reported on (1) the benefits, costs, and trade-offs of highway public-private partnerships; (2) how public officials have identified and acted to protect the public interest in these arrangements; and (3) the federal role in highway public-private partnerships and potential changes in this role. The Senate Finance Committee asked GAO to testify on this report and to highlight its discussion of tax issues. GAO reviewed the experience of projects in the U.S. (including the Chicago Skyway and Indiana Toll Road agreements), Australia, Canada, and Spain.

What GAO Recommends

This testimony makes no new recommendations. In February 2008, GAO recommended that Congress consider directing the Secretary of Transportation, in consultation with Congress and other stakeholders, to develop objective criteria for identifying potential national public interests in highway public-private partnerships, in order to allow the Department of Transportation (DOT) to play a targeted role in ensuring that national interests are considered.

To view the full product, including the scope and methodology, click on GAO-08-1052T. For more information, contact JayEtta Hecker at (202) 512-2834 or heckerj@gao.gov.

What GAO Found

Highway public-private partnerships provide potential benefits, such as sharing risks with the private sector, more efficient operations and management of facilities and, through the use of tolling, increased mobility and more cost-effective investment decisions. There are also potential costs and trade-offs—there is no "free" money in public-private partnerships and it is likely that tolls on a privately operated highway will increase to a greater extent than they would on a publicly operated toll road. There are also financial trade-offs. Unlike public toll authorities, the private sector pays federal income taxes and can deduct depreciation on assets for which they have effective ownership. The extent of these deductions and the amount of foregone revenue, if any, to the federal government is difficult to determine. Demonstrating effective ownership may require lengthy concession periods and, according to experts involved in the lease of the Chicago Skyway and Indiana Toll Road, contributed to the 99-year and 75-year concession terms on these two facilities, respectively. Experts also told us that in the absence of the depreciation benefit, the concession payments to Chicago and Indiana would likely have been less than $1.8 billion and $3.8 billion, respectively.

Highway public-private partnerships in the U.S. that GAO reviewed sought to protect the public interest largely through concession agreement terms prescribing performance and other standards. While these protections are important, governments in other countries, such as Australia, have developed systematic approaches to identifying and evaluating public interest and require their use when considering private investments in public infrastructure. Similar tools have been used to some extent in the United States, but their use has been more limited. Using up-front tools can also assist public agencies in determining the expected benefits and costs of a project and an appropriate means to deliver the project. Not using such tools may lead to certain aspects of protecting the public interest being overlooked.

While direct federal involvement has been limited to where federal investment exists and while the DOT has actively promoted them, highway public-private partnerships may pose national public interest implications such as interstate commerce that transcend whether there is direct federal investment in a project. However, given the minimal federal funding in highway public-private partnerships to date, little consideration has been given to potential national public interests in them. GAO has called for a fundamental reexamination of our surface transportation policies, including creating well-defined goals based on identified areas of national interest. This reexamination provides an opportunity to identify emerging national public interests (including tax considerations), the role of the highway public-private partnerships in supporting and furthering those national interests, and how best to identify and protect national public interests in future highway public-private partnerships.

July 24, 2008

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on public-private partnerships and their role in the surface transportation system. As you know, America's transportation system is the essential element that facilitates the movement of both people and freight within the country. Nevertheless, the current federal approach to addressing the nation's surface transportation problems is not working well. Despite large increases in expenditures in real terms for transportation, the investment has not commensurately improved the performance of the nation's surface transportation system, as congestion continues to grow and looming problems from the anticipated growth in travel demand are not being adequately addressed. We have called for a fundamental reexamination of our surface transportation policies, including creating well-defined goals based on identified areas of national interest, incorporating performance and accountability into funding decisions, and more clearly defining the role of the federal government as well as the roles of state and local governments, regional entities, and the private sector.

The private sector has long been involved in surface transportation as contractors in the design and construction of highways. In recent years, the private sector has become increasingly involved in assuming other responsibilities including planning, designing, and financing. Under some of these arrangements, the private sector is being looked to not only to construct facilities, but also to finance, maintain, and operate facilities under long-term concession agreements—up to 99 years in one case. In some cases, this involves financing and constructing a new facility and then operating and maintaining it over a specified period of time. In other cases, this involves operating and maintaining an existing toll road for a period of time in exchange for an up-front payment provided to the public sector and the right to collect tolls over the term of the agreement.

We recently issued a report on public-private partnerships in the highway sector. For this hearing, you asked us to discuss this report—in particular, the financing and tax issues it raised. My remarks today are based on this February 2008 report[1] and focus on (1) the benefits, costs, and trade-offs

[1]GAO, *Highway Public-Private Partnerships: More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest*, GAO-08-44 (Washington, D.C.: Feb. 8, 2008).

to the public sector associated with highway public-private partnerships; (2) how public officials have identified and acted to protect the public interest in highway public-private partnerships; and (3) the federal role in highway public-private partnerships and potential changes in this role. We performed our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We limited the term "highway public-private partnerships" to highway-related projects in which the public sector enters into a contract, lease, or concession agreement with a private sector firm or firms, and where the private sector provides transportation services such as designing, constructing, operating, and maintaining the facility, usually for an extended period of time. This definition included long-term concessions for toll roads in which the private sector firm(s) receives some or all toll revenues over the life of the lease or concession agreement with the public sector. There are numerous other types of arrangements classified as "public-private partnerships" that we did not include. For example, we did not include fee-for-service arrangements in which effective ownership of a transportation facility does not transfer to the private sector. We also recognize that there may be other forms of highway public-private partnerships. We did not include these types of public-private partnerships in the scope of our work, and the findings and conclusions of our work cannot be extrapolated to those or other types of public-private partnerships.

In summary:

- Highway public-private partnerships have resulted in advantages for state and local governments, such as obtaining new facilities and value from existing facilities without using public funding. The public can potentially obtain other benefits, such as sharing risks with the private sector, more efficient operations and management of facilities, and, through the use of tolling, increased mobility and more cost-effective investment decisions. There are also potential costs and trade-offs. There is no "free" money in public-private partnerships. They are potentially more costly to the public and it is likely that tolls on a privately operated highway will increase to a greater extent than they would on a publicly operated toll road. There is also the risk of tolls being set that exceed the costs of the facility, including a reasonable rate of return, should a private concessionaire gain

market power because of the lack of viable travel alternatives. There are also financial trade-offs. Unlike public toll authorities, the private sector pays federal income taxes and can deduct depreciation on assets for which they have effective ownership for tax purposes. The extent of these deductions and the amount of the foregone revenue, if any, to the federal government is difficult to determine. Obtaining these deductions may also require lengthy concession periods. According to experts involved in the lease of the Chicago Skyway and the Indiana Toll Road, demonstrating effective ownership contributed to the 99-year and 75-year concession terms for the two facilities, respectively. Financial experts also told us that in the absence of the depreciation benefit, the concession payments to Chicago and Indiana would likely have been less than the $1.8 billion and $3.8 billion, respectively.

- Highway public-private partnerships in the U.S. we have reviewed sought to protect the public interest largely through concession agreement terms prescribing performance and other standards. While these protections are important, governments in other countries, including Australia and the United Kingdom, have developed systematic approaches to identifying and evaluating public interest before agreements are entered into, including the use of public interest criteria, as well as assessment tools, and require their use when considering private investments in public infrastructure. For example, a state government in Australia uses a public interest test to determine how the public interest would be affected in eight specific areas, including whether the views and rights of affected communities have been heard and protected and whether the process is sufficiently transparent. While similar tools have been used to some extent in the United States, their use has been more limited. Using up-front public interest analysis tools can also assist public agencies in determining the expected benefits and costs of a project and an appropriate means to deliver the project. Not using such tools may lead to certain aspects of protecting the public interest being overlooked.

- Direct federal involvement in highway public-private partnerships has generally been limited to projects in which federal requirements must be followed because federal funds have or will be used. While direct federal involvement has been limited, the Department of Transportation (DOT) has done much to promote highway public-private partnerships, but comparatively little to either assist states and localities in weighing potential costs and trade-offs, or to assess how potentially important national interests might be protected in such arrangements. Given the minimal federal funding in highway public-private partnerships to date, little consideration has been given to potential national public interests in them. Highway public-private partnerships may pose national public

interest implications such as interstate commerce that transcend whether there is direct federal investment in a project. The historic test of the presence of federal funding may have been relevant at a time when the federal government played a larger role in financing highways but may no longer be relevant when there are new players and multiple sources of financing, including potentially significant private money. We have called for a fundamental reexamination of federal programs to address emerging needs and test the relevance of existing policies. Such a reexamination provides an opportunity to identify emerging national public interests (including tax considerations), the role of highway public-private partnerships in supporting and furthering those national interests, and how best to identify and protect national public interests in future public-private partnerships. We believe DOT has the opportunity to play a targeted role in ensuring that national interests are considered, as appropriate, and have suggested that Congress consider directing the Secretary of Transportation to develop and submit objective criteria for identifying national public interests in highway public-private partnerships, including any additional legal authority, guidance, or assessment tools that would be appropriately required. We recognize this is no easy task—any potential federal restrictions on highway public-private partnerships must be carefully crafted to avoid undermining the potential benefits that can be achieved.

Highway Public-Private Partnerships Can Potentially Provide Benefits but Also Entail Costs, Risks, and Trade-offs

Highway public-private partnerships have the potential to provide numerous benefits to the public sector. There are also potential costs and trade-offs.

Potential Benefits

Highway public-private partnerships created to date have resulted in advantages from the perspective of state and local governments, such as the construction of new infrastructure without using public funding and obtaining funds by extracting value from existing facilities for reinvestment in transportation and other public programs. For example, the state of Indiana received $3.8 billion from leasing the Indiana Toll Road and used those proceeds to fund a 10-year statewide transportation plan. As we reported in 2004, by relying on private-sector sponsorship and investment to build roads rather than financing the construction

themselves, states (1) conserve funding from their highway capital improvement programs for other projects, (2) avoid the up-front costs of borrowing needed to bridge the gap until toll collections became sufficient to pay for the cost of building the roads and paying the interest on the borrowed funds, and (3) avoid the legislative or administrative limits that govern the amount of outstanding debt these states are allowed to have.[2] All of these results are advantages for the states.

Highway public-private partnerships potentially provide other benefits, including the transfer or sharing of project risks to the private sector. Such risks include those associated with construction costs and schedules and having sufficient levels of traffic and revenues to be financially viable. Various government officials told us that because the private sector more reliably analyzes its costs, revenues, and risks throughout the life cycle of a project and adheres to scheduled toll increases, it is able to accept large amounts of risk at the outset of a project, although the private sector prices all project risks and bases its final bid proposal, in part, on the level of risk involved. In addition, the public sector can potentially benefit from increased efficiencies in operations and life-cycle management, such as increased use of innovative technologies.

Highway public-private partnerships can also potentially provide mobility and other benefits to the public sector, through the use of tolling. The highway public-private partnerships we reviewed all involved toll roads. These benefits include better pricing of infrastructure to reflect the true costs of operating and maintaining the facility and thus improved condition and performance of public infrastructure, as well as the potential for more cost effective investment decisions by private investors. In addition, through congestion pricing, tolls can be set to vary during congested periods to maintain a predetermined level of service, creating incentives for drivers to consider costs when making their driving decisions, and potentially reducing the demand for roads during peak hours.

Potential Costs, Risks, and Trade-offs

Although highway public-private partnerships can be used to obtain financing for highway infrastructure without the use of public sector funding, there is no "free money" in highway public-private partnerships.

[2]GAO, *Highways and Transit: Private Sector Sponsorship of and Investment in Major Projects Has Been Limited*, GAO-04-419 (Washington, D.C.: Mar. 25, 2004).

Rather, this funding is a form of privately issued debt that must be repaid. Private concessionaires primarily make a return on their investment by collecting toll revenues. Though concession agreements can limit the extent to which a concessionaire can raise tolls, it is likely that tolls will increase on a privately operated highway to a greater extent than they would on a publicly run toll road. Tolls are generally set in accordance with concession agreements and, in contrast to public-sector practices, allowable toll increases can be frequent and automatic. The public sector may lose control over its ability to influence toll rates, and there is also the risk of tolls being set that exceed the costs of the facility, including a reasonable rate of return if, for example, a private concessionaire gains market power because of the lack of viable travel alternatives. In addition, highway public-private partnerships also potentially require additional costs to the public sector compared with traditional public procurement, including the costs associated with (1) required financial and legal advisors, and (2) private-sector financing compared with public-sector financing.

In addition to potentially higher tolls, the public sector may give up more than it receives in a concession payment in using a highway public-private partnership with a focus on extracting value from an existing facility. In exchange for an up-front concession payment, the public sector gives up control over a future stream of toll revenues over an extended period of time, such as 75 or 99 years. It is possible that the net present value of the future stream of toll revenues (less operating and capital costs) given up can be much larger than the concession payment received. Concession payments could potentially be less than they could or should be. Conversely, because the private sector takes on substantial risks, the opposite could also be true—that is, the public sector might gain more than it gives up.

Using a highway public-private partnership to extract value from an existing facility also raises issues about the use of those proceeds and whether future users might potentially pay higher tolls to support current benefits. In some instances, up-front payments have been used for immediate needs, and it remains to be seen whether these uses provide long-term benefits to future generations who will potentially be paying progressively higher toll rates to the private sector throughout the length of a concession agreement. Both Chicago and Indiana used their lease fees, in part, to fund immediate financial needs. Both also established long-term reserves from the lease proceeds. Conversely, proceeds from the lease of Highway 407 ETR in Toronto, Canada, went into the province's general revenue fund.

Financial Trade-offs

Trade-offs from the public perspective can also be financial, as highway public-private partnerships have implications for federal tax policy. Private firms generally do not realize profits in the first 10 to 15 years of a concession agreement. However, the private sector receives benefits from highway public-private partnerships over the term of a concession in the form of a return on its investment. Private-sector investors generally finance large public-sector benefits early in a concession period, including up-front payments for leases of existing projects or capital outlays for the construction of new, large-scale transportation projects. In return, the private sector expects to recover any and all up-front costs, as well as ongoing maintenance and operation costs, and generate a return on investment. Furthermore, any cost savings or operational efficiencies the private sector can generate, such as introducing electronic tolling, improving maintenance practices, or increasing customer satisfaction in other ways, can further boost the return on investment through increased traffic flow and increased toll revenue.

Unlike public toll authorities, private-sector firms pay federal income tax. Current tax law allows private sector firms to deduct depreciation on assets involved with highway public-private partnerships for which they have "effective ownership." Effective ownership of assets requires, among other things, that the length of a concession agreement be equal to or greater than the useful economic life of the asset. According to financial and legal experts, including those who were involved in the lease of the Chicago Skyway in Chicago, Illinois, and the Indiana Toll Road, the useful economic life of those facilities was lengthy. The requirement to demonstrate effective asset ownership thus required lengthy partnership concession periods and contributed to the 99-year and 75-year concession terms for the Chicago Skyway and Indiana Toll Road, respectively. These financial and legal experts told us that as effective owners, the private investors can claim full tax deductions for asset depreciation within the first 15 years of the lease agreements.[3]

Determining the extent of depreciation deductions associated with highway public-private partnerships, and the extent of foregone revenue to the federal government, if any, from these deductions is difficult to

[3]Depreciation is the accounting process of allocating against revenue the cost expiration of tangible property, plant, and equipment. Under straight-line depreciation, an equal amount of depreciation expense is taken annually over the life of the asset. Under accelerated depreciation, a depreciation expense is taken that is higher than annual straight-line amount in the early years and lower in later years.

determine because they depend on such factors as taxable income, total deductions, and marginal tax rates of private-sector entities involved with highway public-private partnerships. Financial experts told us that in the absence of the depreciation benefit, the concession payments to Chicago and Indiana would likely have been less than the $1.8 billion and $3.8 billion paid, respectively.

However, foregone revenue to the federal government from tax benefits associated with transportation projects can potentially amount to millions of dollars.[4] For example, as we reported in 2004, foregone tax revenue when the private-sector used tax-exempt bonds to finance three projects with private sector involvement—the Pocahontas Parkway, Southern Connector, and Las Vegas Monorail—were between $25 million and $35 million.[5]

Highway Public-Private Partnerships Have Sought to Protect Public Interest in Many Ways, but Use of Public Interest Criteria Is Mixed in the United States

The public interest in highway public-private partnerships can and has been considered and protected in many ways. State and local officials in the U.S. projects we reviewed heavily relied on concession terms. Most often, these terms were focused on, among other things, ensuring performance of the asset, dealing with financial issues, and maintaining the public sector's accountability and flexibility. Included in the protections we found in agreements we reviewed were:

- Operating and maintenance standards: These standards are put in place to ensure that the performance of the asset is upheld to high safety, maintenance, and operational standards and can be expanded when necessary. For example, based on documents we reviewed, the standards on the Indiana Toll Road require the concessionaire to maintain the road's condition, utility, and level of safety including a wide range of roadway issues, such as signage, use of safety features such as barrier walls, snow and ice removal, and the level of pavement smoothness that must be maintained.
- Expansion trigger requirements: These triggers require that a concessionaire expand a facility once congestion reaches a certain level. Some agreements can be based on forecasts. For example, on the Indiana

[4]GAO-04-419.

[5]According to DOT officials, these projects were financed through models different than the public-private partnerships that are were the focus of our February 2008 report.

Toll Road, when service is forecasted to fall below certain levels within 7 years, the concessionaire must act to improve service, such as by adding additional capacity at its own cost.

- Revenue-sharing mechanisms: These mechanisms require a concessionaire to share some level of revenues with the public sector. For example, on one Texas project, if the annual return on investment of the private concessionaire is at or below 11 percent, then the state could share in 5 percent of all revenues. If it is over 15 percent, the state could receive as much as 50 percent of the net revenues.

While these protections are important, governments in other countries, including Australia and the United Kingdom, have developed systematic approaches to identifying and evaluating public interest before agreements are entered into, including the use of public interest criteria, as well as assessment tools, and require their use when considering private investments in public infrastructure. These tools include the use of qualitative public interest tests and criteria to consider when entering into public-private partnerships. For example, a state government in Australia uses a public interest test to determine how the public interest would be affected in eight specific areas, including whether the views and rights of affected communities have been heard and protected and whether the process is sufficiently transparent. These tools also include quantitative tests such as Value for Money and public sector comparators, which are used to evaluate if entering into a project as a public-private partnership is the best procurement option available.

While similar tools have been used to some extent in the United States, their use has been more limited. For example, Oregon hired a consultant to develop public-sector comparators to compare the estimated costs of a proposed highway public-private partnership with a model of the public sector's undertaking the project. According to the Innovative Partnerships Project Director in the Oregon DOT, the results of this model were used to determine that the added costs of undertaking the project as a public-private partnership (given the need for a return on investment by the private investors) were not justifiable given the limited value of risk transfer in the project. While this study was conducted before the project was put out for official concession, it was prepared after substantial early development work was done by private partners. Neither Chicago nor Indiana had developed public interest tests or other tools prior to the leasing of the Chicago Skyway or the Indiana Toll Road.

Using up-front public interest analysis tools can assist public agencies in determining the expected benefits and costs of a project and an appropriate means to undertake the project. Not using such tools may lead to certain aspects of protecting public interest being overlooked. For example, concerns by local and regional governments in Texas helped drive statewide legislation requiring the state to involve local and regional governments to a greater extent in future highway public-private partnerships. Elsewhere, in Toronto, Canada, the lack of a transparency about the toll rate structure and misunderstanding about the toll structure of the Highway 407 ETR facility was a major factor in significant opposition to the project.

Direct Federal Involvement with Highway Public-Private Partnerships Has Generally Been Limited, but Identification of National Interests in Highway Public-Private Partnerships Has Been Lacking

Direct federal involvement in highway public-private partnerships has generally been limited to projects in which federal requirements must be followed because federal funds have or will be used. At the time of our February 2008 report, minimal federal funding has been used in highway public-private partnerships. While direct federal involvement has been limited, the administration and the DOT have actively promoted highway public-private partnerships through policies and practices, including the development of experimental programs that waive certain federal regulations and encourage private investment. For example, until August 2007, federal regulations did not allow private contractors to be involved in highway contracts with a state department of transportation until after the federally mandated environmental review process had been completed. Texas applied for a waiver to allow its private contractor to start drafting a comprehensive development plan to guide decisions about the future of the corridor before its federal environmental review was complete. These flexibilities were pivotal to allowing highway public-private partnership arrangements in both Texas and Oregon to go forward while remaining eligible for federal funds. The Federal Highway Administration (FHWA) and DOT also promoted highway public-private partnerships by developing publications to educate state transportation officials about highway public-private partnerships and to promote their use, drafting model legislation for states to consider to enable highway public-private partnerships in their states, creating a public-private partnership Internet Web site, and making tolling a key component of DOT's congestion mitigation initiatives.

Recent highway public-private partnerships have involved sizable investments of funds and significant facilities and could pose national public interest implications such as interstate commerce that may transcend whether there is direct federal investment in a project. For

example, both the Chicago Skyway and the Indiana Toll Road are part of the Interstate Highway System; the Indiana Toll Road is part of the most direct highway route between Chicago and New York City and, according to one study, over 60 percent of its traffic is interstate in nature. However, federal officials had little involvement in reviewing the terms of either of these concession agreements before they were signed. In the case of Indiana, FHWA played no role in reviewing either the lease or national public interests associated with leasing the highway, nor did it require the state of Indiana to review these interests. Texas envisions constructing new international border crossings and freight corridors using highway public-private partnerships, which may greatly facilitate North American Free Trade Agreement-related truck traffic to other states. However, no federal funding had been expended in the development of the project. Given the minimal federal funding in highway public-private partnerships to date, few mechanisms exist to consider potential national public interests in them. For example, FHWA officials told us that no federal definition of public interest or federal guidance on identifying and evaluating public interest exists.

The absence of a clear identification and furtherance of national public interests in the national transportation system is not unique to highway public-private partnerships. We have called for a fundamental reexamination of the nations surface transportation policies, including creating well-defined goals based on identified areas of national interest, incorporating performance and accountability into funding decisions, and more clearly defining the role of the federal government as well as the roles of state and local governments, regional entities, and the private sector. Such a reexamination provides an opportunity to identify emerging national public interests (including tax considerations), the role of the highway public-private partnerships in supporting and furthering those national interests, and how best to identify and protect national public interests in future public-private partnerships.

Concluding Observations

Highway public-private partnerships show promise as a viable alternative, where appropriate, to help meet growing and costly transportation demands. The public sector can acquire new infrastructure or extract value from existing infrastructure while potentially sharing with the private sector the risks associated with designing, constructing, operating, and maintaining public infrastructure. However, highway public-private partnerships are not a panacea for meeting all transportation system demands, nor are they without potentially substantial costs and risks to the public—both financial and nonfinancial—and trade-offs must be made.

Highway public-private partnerships are fairly new in the United States, and, although they are meant to serve the public interest, it is difficult to be confident that these interests are being protected when formal identification and consideration of public and national interests has been lacking, and where limited up-front analysis of public interest issues using established criteria has been conducted. Consideration of highway public-private partnerships could benefit from more consistent, rigorous, systematic, up-front analysis. Benefits are potential benefits—that is, they are not assured and can only be achieved by weighing them against potential costs and trade-offs through careful, comprehensive analysis to determine whether public-private partnerships are appropriate in specific circumstances and, if so, how best to implement them.

Despite the need for careful analysis, the approach at the federal level has not been fully balanced, as DOT has done much to promote the benefits, but comparatively little to either assist states and localities weigh potential costs and trade-offs, nor to assess how potentially important national interests might be protected in highway public-private partnerships. We have suggested that Congress consider directing the Secretary of Transportation to develop and submit objective criteria for identifying national public interests in highway public-private partnerships, including any additional legal authority, guidance, or assessment tools that would be appropriately required. We are pleased to note that in a recent testimony before the House, the Secretary indicated a willingness to begin developing such criteria. This is no easy task, however. The recent report by the National Surface Transportation Policy and Revenue Study Commission illustrates the challenges of identifying national public interests as the Policy Commission's recommendations for future restrictions—including limiting allowable toll increases and requiring concessionaires to share revenues with the public sector—stood in sharp contrast to the dissenting views of three commissioners.[5] We believe any potential federal restrictions on highway public-private partnerships must be carefully crafted to avoid undermining the potential benefits that can be achieved. Reexamining the federal role in transportation provides an opportunity for DOT, we believe, to play a targeted role in ensuring that national interests are considered, as appropriate.

[5]*Transportation for Tomorrow*, National Surface Transportation Policy and Revenue Study Commission, Dec. 2007.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee might have.

GAO Contact and Staff Acknowledgment

For further information on this statement, please contact JayEtta Z. Hecker at (202) 512-2834 or heckerj@gao.gov. Individuals making key contributions to this testimony were Steve Cohen (Assistant Director), Bert Japikse, Richard Jorgenson, Carol Henn, Matthew Rosenberg, and James White.

Responses to Questions for the Record From JayEtta Hecker
Subcommittee on Energy, Natural Resources, and Infrastructure Hearing
"Tax and Financing Aspects of Highway Public-Private Partnerships"
July 24, 2008

Questions From Senator Bingaman

1. My staff estimates that the State of Indiana continues to receive at least $10 million in federal formula highway funding per year related to the traffic using the Indiana Toll Road, even though the state has handed over control to a private company. Isn't this double dipping? Does it make sense to continue federal funding based on interstate lane miles for interstate lanes that the state doesn't maintain?

Our work on highway public-private partnerships did not specifically address the issue of federal-aid highway formula funds to the states. It would be difficult, Mr. Chairman, for us to offer any views without first doing additional research. We would be pleased to meet with you or members of your staff if you would like to pursue this question further.

2. One concern I have about the administration's head-long rush into public-private partnerships is that it may put the parochial interests of one state, and the private investors, ahead of the national interest. I wonder if you share that concern and what we might do to address it.

Highway public-private partnerships are fairly new in the United States, Mr. Chairman, and, although they are meant to serve the public interest, it is difficult, as I testified, to be confident that these interests are being protected when formal identification and consideration of public and national interests has been lacking. Despite the need for more careful, consistent, rigorous, systematic, up-front analysis, the approach at the federal level has not been fully balanced, as the Department of Transportation (DOT) has done much to promote the benefits, but comparatively little to either assist states and localities weigh potential costs and trade-offs, nor to assess how potentially important national interests might be protected in highway public-private partnerships.

We have suggested that Congress consider directing the Secretary of Transportation to develop and submit objective criteria for identifying national public interests in highway public-private partnerships, including any additional legal authority, guidance, or assessment tools that would be appropriately required. We are pleased to note that in a testimony earlier this year before the House, the Secretary indicated a willingness to begin developing such criteria. We recognize that this is no easy task, but we believe an opportunity exists, where clearly defined national interests are involved, for DOT to play a targeted role in ensuring those national interests are considered and protected, as appropriate.

3. GAO has studied the European and Australian experiences with public-private highway partnerships. Are non-compete clauses standard in Europe?

The use of non-compete clauses varied in the overseas cases we studied. For example, we visited Australia, where non-compete clauses are used and are part of concession agreements for public-private highway partnerships. However, in one case, the CityLink project in Melbourne, there was no non-compete clause. Nevertheless, the concessionaire sued the government of the state of Victoria when a competing road was built. At the time of our review, that suit was pending in the courts. In another Australian state, New South Wales, non-compete clauses are based on "adverse impacts". To receive compensation, the concessionaire must demonstrate that the construction of a roadway or transit facility led to material adverse impacts to the toll road. In some instances, transit options are exempted. In Spain, which we also visited, non-compete clauses are not standard in concession agreements for highway public-private partnerships. However, we were told a de facto policy exists that every toll road has to have a free alternative. Generally however, alternative facilities are not built to the same standards and do not offer the same levels of service in terms of traffic flow and speeds.

JOINT COMMITTEE ON TAXATION
July 24, 2008
JCX-62-08

TESTIMONY OF EDWARD D. KLEINBARD
CHIEF OF STAFF
OF THE
JOINT COMMITTEE ON TAXATION

AT A HEARING OF THE SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE OF THE COMMITTEE ON FINANCE ON "TAX AND FINANCING ASPECTS OF HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS"[1]

JULY 24, 2008

Mr. Chairman, Senator Bunning, members of the Subcommittee, my name is Edward D. Kleinbard and I am the Chief of Staff of the Joint Committee on Taxation. I am pleased to have the opportunity to appear before you today to discuss the Federal income tax issues raised by the use of public-private partnerships[2] to build, manage and own highways in the United States. At the request of the Subcommittee, my remarks are focused on "brownfield" highway projects, which involve very long-term leases of existing infrastructure from a State or other public owner to private parties. I also cover the present law treatment of tax-exempt bond financing for highway projects, in the context of both public and private owners of highway infrastructure.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Testimony of Edward D. Kleinbard, Chief of Staff of the Joint Committee on Taxation, at a Hearing of the Subcommittee on Energy, Natural Resources, and Infrastructure of the Committee on Finance on "Tax and Finance Aspects of Highway Public-Private Partnerships"* (JCX-XX-08), July 24, 2008. This document is available at www.jct.gov.

[2] Although referred to as "public-private partnerships," the parties generally do not intend the arrangement to be treated as a partnership for Federal income tax purposes. The discussion in this testimony assumes that this intended treatment is respected.

Overview of public-private partnerships

The Department of Transportation defines public-private partnerships broadly to include "contractual agreements formed between a public agency and private sector entity that allow for greater private sector participation in the delivery of transportation projects."[3] The private sector historically has participated in the design and construction of United States highways, most commonly as contractors to the public sector. A public-private partnership, however, generally is understood as shifting more of the economic risks (and attendant rewards) of a transportation project to the private sector than would be the case in a traditional public owner-private contractor relationship. For example, a public-private partnership might contemplate a private firm taking on all the design and construction risks for a new project, or a private firm operating a project for a period of years following construction, and obtaining an economic return based on the relative success of its management. State and local governments have shown increasing interest in public-private partnership arrangements as the cost of infrastructure development and maintenance continues to increase.[4]

Some private firms have acquired economic interests in the financing, maintenance, and operation of public highways after they are built.[5] Two well-publicized arrangements, involving the Chicago Skyway and the Indiana Toll Road, illustrate how the public-private partnership concept can be applied to transfers of economic interests in existing highways from the public sector to private firms. In my testimony, I will use the similar structures of these two transactions as a template, but my remarks should be understood as generic in nature, and do not rely on any taxpayer-specific information not in the public domain.

The Chicago Skyway and Indiana Toll Road deals were structured as very long-term arrangements: 99 years in the former case, and 75 in the latter. For tax purposes, each transaction can be seen as comprising three operating relationships, each of which in turn runs for the length of the overall arrangement:

(1) A lease of the existing infrastructure (the highway itself and associated improvements) from the public owner to the private firm;[6]

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[3] U.S. Department of Transportation, Federal Highway Administration, Public-Private Partnership Website, "PPPs Defined," [http://www.fhwa.dot.gov/PPP/defined.htm].

[4] For background on infrastructure investment, see Congressional Budget Office, *Issues and Options in Infrastructure Investment* (May 2008) (public-private partnership discussion at page 32).

[5] For background on public-private partnerships, see CRS Report RL34567, *Public-Private Partnerships in Highway and Transit Infrastructure Provision*, by William J. Mallett (July 9, 2008); GAO, *Highway Public-Private Partnerships, More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest*, GAO-08-44 (Washington, DC: February 2008).

[6] Technically the private party in each case was itself a partnership among several private firms, but this point is not relevant to the tax issues considered in my testimony.

(2) A grant by the public owner to the private firm of a right-of-way on the public lands underlying that infrastructure; and

(3) A grant of a franchise from the public entity permitting the private party to collect tolls on the highway.

In return, the private party paid a large up-front amount to the public owner, and agreed to operate and maintain the road, to invest specified amounts in future improvements, and to accept restrictions on the maximum tolls it could change.[7] An umbrella concession agreement sets out the long-term rights and obligations of each party, including dispute resolution mechanisms.

More specifically, in 2004, the City of Chicago leased the Chicago Skyway, a 7.8 mile toll road south of downtown Chicago that connects two major highways, in the first long-term lease of an existing toll road in the United States. Under the 99-year concession agreement with Skyway Concession Company Holdings LLC, a joint venture between Cintra of Madrid, Spain, and Macquarie of Sydney, Australia,[8] the City of Chicago received a $1.8 billion up-front payment in exchange for granting the private concessionaire the exclusive right to use, possess, operate, manage, maintain, rehabilitate, and collect tolls from the Chicago Skyway.

In 2006, the Indiana Finance Authority ("IFA") entered into a 75-year concession agreement with ITR Concession Company LLC ("ITR"), also a joint venture between Cintra and Macquarie, in respect of the Indiana Toll Road. IFA received a $3.8 billion up-front payment in exchange for granting ITR the exclusive right to operate, manage, maintain, rehabilitate, and collect tolls from the Indiana Toll Road.

The remainder of my testimony provides background on the Federal income tax policy issues raised by these arrangements and their tax treatment under present law.[9]

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[7] See summaries of these arrangements at U.S. Department of Transportation, Federal Highway Administration, Public-Private Partnership Website, "PPP Case Studies," [http://www.fhwa.dot.gov/ppp/case_studies.htm]. In addition to the Chicago Skyway and Indiana Toll Road arrangements, the Pocahontas Parkway in southern Virginia is being leased through a public-private partnership arrangement, and other similar transactions are being considered by State legislatures. The Pennsylvania General Assembly, for example, currently is considering a $12.8 billion bid by Citigroup and Abertis Infraestructuras for a 75-year lease of the Pennsylvania turnpike, [http://www.efinancialnews.com/usedition/index/content/2451015346].

[8] "Cintra" and "Macquarie" refer to these companies generally. In the case of Skyway Concession Company Holdings LLC, the investment is owned, indirectly, by Cintra Concesiones de Infraestructuras de Transporte, SA and Macquarie Infrastructure Group.

[9] For analysis of other public policy issues raised by public-private partnerships, see CRS Report RL34567, *Public-Private Partnerships in Highway and Transit Infrastructure Provision*, by William J. Mallett (July 9, 2008); GAO, *Highway Public-Private Partnerships, More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest*, GAO-08-44 (Washington, DC: February 2008); U.S. Department of Transportation, *Report to Congress on the Costs, Benefits, and Efficiencies of Public-Private Partnerships for Fixed Guideway Capital Projects* (November 2007); Craig

Characterization of public-private partnerships for tax purposes

The parties to the archetypal brownfield public-private partnerships under consideration here enter into an umbrella concession agreement that describes the overall business relationship. Very importantly, the deals appear to be carefully structured *not* to constitute partnerships for tax purposes. (If the transaction were characterized as a constructive tax partnership, there would be a great many adverse consequences for the parties, including the possible application of Internal Revenue Code section 470 and differences in the tax depreciation rules for the brownfield assets.)[10] Instead, and as described above, the arrangements are intended to be treated for tax purposes as transfers of three separate bundles of property rights from the public owner to the private firm, all in exchange for the lump sum cash payment:

(1) A "lease" of the infrastructure assets;

(2) A lease of the land underlying the infrastructure assets (the right of way); and

(3) A grant of an intangible "franchise" right to collect tolls.

The "public-private partnership" label thus generally is a red herring for the tax analysis of these transactions.

To be clear, it is possible that future transactions might raise more difficult questions of whether a constructive tax partnership exists between the public and private entities that enter into a brownfield transaction. In particular, transactions that rely more on back-end revenue sharing and that contemplate a larger continuing management role for the public entity would require analysis. For purposes of this testimony, however, I assume that the transactions will be respected according to their form, as outright transfers of the three bundles of property rights described above.

In turn, under long-established tax principles, the "lease" of the infrastructure assets would be expected to be characterized as an outright purchase of those assets by the private firm for tax purposes, because the "lessee" has acquired all the benefits and burdens of ownership of those assets for a term that significantly exceeds their expected remaining useful life.[11] Land, by

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L. Johnson, Martin J. Luby, and Shokhrukh I. Kurbanov, *Toll Road Privatization Transactions: The Chicago Skyway and Indiana Toll Road*, September 2007, [http://www.cviog.uga.edu/services/research/abfm/johnson.pdf].

[10] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and all regulation references are to the Treasury Regulations promulgated thereunder.

[11] To the extent the property under the concession agreement becomes owned directly or indirectly by non-U.S. persons, the U.S. business operations related to the property generally should be subject to net-basis U.S. taxation in the same manner as if the property were owned by U.S. persons. If those U.S. business operations were conducted through a domestic corporation, the corporation would be subject to corporate tax on the income from the operations. Sec. 11. Certain payments (such as dividends) to foreign owners of the corporation would be subject to U.S. withholding tax (subject to reduction or elimination under bilateral income tax treaties). If the U.S. business operations were

contrast, is deemed for tax purposes to have a perpetual useful life, and as a result the long-term ground lease would be expected to be characterized as such.

More specifically, the concession agreement signed by the parties generally is for a period much longer than the economic useful life of the highway assets, which (along with operating control) is the critical question in determining whether a purported lease should be recharacterized as a purchase of assets for tax purposes. The Bureau of Economic Analysis estimates the service life of highways and streets to be 45 years,[12] while the Chicago Skyway and Indiana Toll Road agreements were for terms of 99 and 75 years, respectively. The private party's responsibilities under the agreement may include all operations of the toll road, payment of utilities, maintenance, taxes (the private party may not be required to pay certain real estate, sales, and other taxes), capital improvements, risk of loss, and liabilities that arise during the term.[13] Accordingly, while the facts and circumstances of each transaction will control its tax treatment, these arrangements will most likely be viewed by the parties as a sale and purchase of a trade or business, and the concession agreement can be expected to include a provision describing the intended tax treatment in this manner.[14]

It also follows from the above that tax considerations are very important drivers of the long-term nature of these arrangements. Private firms can be expected to want to obtain the tax

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conducted through a foreign corporation, the corporation would be subject to U.S. tax on its effectively connected income. Sec. 882. Moreover, the foreign corporation could be subject to branch profits tax and branch interest tax on, respectively, dividend-like withdrawals from the U.S. business and certain interest payments allocable to the business. Sec. 884(a), (f). "Earnings stripping" rules (discussed later in the "Financing the acquisition" section of this testimony) also could apply to disallow deductions for certain interest payments to related parties and interest payments on debt guaranteed by related parties.

Finally, the special U.S. tax rules applicable to foreign investment in U.S. real estate (the "FIRPTA" rules of section 897) may affect the U.S. tax treatment of foreign investors. We understand that some advisors have taken the position that the intangible franchise right is an interest in real property for purposes of section 897. Other advisors have taken a contrary view. Treating the franchise right as an interest in real property would make it more likely that a domestic corporation that owned the right would be a U.S. real property holding corporation under section 897(c)(2) and, therefore, that tax under section 897 would be triggered by, for example, a sale of the corporation by foreign investors.

[12] U.S. Department of Commerce, Bureau of Economic Analysis, *BEA Depreciation Estimates*, [http://www.bea.gov/national/FA2004/Tablecandtext.pdf].

[13] We have not reviewed all public-private partnership agreements. The terms will vary depending on the particular arrangement.

[14] For example, Section 2.8 of the *Indiana Toll Road Concession and Lease Agreement*, (April 12, 2006) states: "This Agreement is intended for U.S. federal and state income tax purposes to be a sale of the Toll Road Facilities and Toll Road Assets to Concessionaire and the grant to the Concessionaire of an exclusive franchise and license for and during the Term to provide Toll Road Services within the meaning of sections 197(d)(1)(D) and (E) of the Internal Revenue Code of 1986, as amended, and sections 1.197-2(b)(8) and (10) of the Income Tax Regulations thereunder," [http://www.in.gov/ifa/files/4-12-06-Concession-Lease-Agreement.pdf].

advantages (in particular, depreciation deductions, as described below) that flow to any owner of an asset. At the same time, the public sector participant will wish to maximize the value it receives for giving up control of the infrastructure assets, by assisting the private firm in being treated as the tax owner of the assets. Because these transactions are nominally leases, the private firm participants will want to assure themselves and their advisors that they will control the assets for a period that clearly exceeds their expected economic life. The result can be seen in the 75 and 99 year terms of the two archetypal transactions considered here.

Tax policy considerations in public-private partnerships

Any transaction between private parties and the public sector — including a public-private partnership with respect to highways or other infrastructure — presents two important sets of questions:

(1) Does the arrangement allow the private party to obtain tax deductions or other tax benefits in respect of property that economically is controlled by the public entity, or conversely to shield from tax income that belongs economically to the private firm by allocating that income to the nontaxable public entity? In other words, are the parties engaged in a bona fide commercial transaction, or are they primarily trading on the public entity's tax-exempt status?

(2) Assuming that the transaction is a bona fide commercial undertaking, are the tax consequences to the private party (including the tax aspects of any financing opportunities available to the private party) similar to the tax results achieved in other economically comparable transactions that take place entirely in the private sphere? That is, is the tax law neutral across comparable investments, thereby avoiding tax-induced economic distortions? Or does the tax law, through tax expenditures, indirectly subsidize this particular activity — and if so, is that subsidy intentional (for example, as an instrument of Federal transportation policy)?

Genuine transaction or trading on tax-exempt status?

Turning to the first question, public-private partnership arrangements of the sort considered here as a general matter are genuine commercial transactions. In particular, these arrangements do not present the issues raised by "lease-in lease-out" ("LILO") or "sale-in, lease-out" ("SILO") transactions, abusive arrangements that have been curtailed by Federal tax legislation.

In a typical LILO or SILO transaction, governmental entities essentially transferred nominal ownership (and with it the rights to Federal tax benefits) relating to public infrastructure assets, such as sewer systems or subway systems, to taxable parties, and simultaneously leased the assets back. Under the complex arrangements between the parties, the original transfer did not result in any meaningful change in the use or management of those systems, or in the benefits and burdens of ownership of the assets; instead the public entity continued to manage the infrastructure, and bear all the attendant economic risks of doing so, through its lease back of the

facility.[15] Moreover, the private party, as nominal owner and lessor of the infrastructure assets, did not take significant credit risk with respect to the public agency's rental payments, all of which were essentially prefunded. Finally, the arrangements contained complex exit provisions that made it very likely that the public entity would reacquire the infrastructure assets at the end of its lease term, thereby assuring that the public entity's economic ownership of the facility essentially would remain unbroken.

Public-private partnership brownfield arrangements of the sort considered here, by contrast, generally appear in fact to transfer beneficial ownership of the infrastructure assets to the private party. In contrast to the LILO/SILO case, there is no lease back of the assets from the private firm to the original public owner. The private firm takes on the operation of the assets, the obligation to maintain and improve the assets, and the associated economic risks and rewards, for the economic life of the assets. The original public owner receives a large upfront payment that, unlike the LILO/SILO case, is available to the original public owner to use for any purpose; that is, the sales price is not in turn used to "defease" any continuing financial obligations to the private party, because there are none. The original public owner therefore has no continuing economic interest in the property over its expected economic life, or at most a modest interest in the form of revenue sharing payments.

While brownfield public-private partnerships of the sort considered here do not raise the deeply troubling tax policy issues exemplified by LILO and SILO deals, it must be remembered that a "public-private partnership" is an amorphous concept, and future transactions, whether in the brownfield arena or elsewhere, conceivably could be structured in more problematic ways. Congress has amended the Code (in section 470) to deal systematically with this issue; future transactions should be monitored to assure that section 470 is operating to reach those transactions that troubled Congress.

A tax-favored investment?

Assuming that the arrangement is a bona fide commercial transaction, the second relevant question is whether the tax consequences to the private party are comparable to the tax results achieved in other economically comparable transactions that take place wholly within the private sphere. That is, is the tax law neutral across comparable investments, thereby avoiding tax-induced economic distortions?

Non-tax public policy considerations may affect the answer to this question. Congress regularly relies on tax expenditures[16] to subsidize certain economic activities but not others, in furtherance of non-tax policy goals. Whether in this instance the tax law should favor, disfavor, or remain neutral with respect to public-private partnerships therefore may depend in significant part on the resolution of Federal transportation policy issues and the extent to which Federal

[15] See IRS Notice 2005-13, 2005-1 C.B. 630, for a description of a SILO transaction and Rev. Rul. 2002-69, 2002-2 C.B. 760, for a description of a LILO transaction. Both of these transactions have been identified by the Internal Revenue Service as listed transactions.

[16] For a general discussion of tax expenditures, see Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008.

subsidies delivered through the tax system are considered an appropriate instrument of those transportation policies. Purely as a matter of economics and tax policy, however, considerations of economic efficiency and consistency would dictate that the tax law should be neutral as between making this type of investment or another type of investment.

It is surprisingly difficult to analyze whether brownfield public-private partnerships are treated neutrally as a matter of income tax economics, for the simple reason that they are very capital-intensive transactions, and the tax rules for the recovery of investments in *all* forms of real (i.e., non-financial) assets are non-neutral. That is, our depreciation system in particular can be argued to grant Federal subsidies for investing in property, plant and equipment, in the form of accelerated depreciation deductions.[17] The practical question here, therefore, is not whether a private investor in a brownfield public-private partnership receives a Federal tax subsidy, when compared to an ideal income tax (the answer may well be yes, it does), but rather whether those subsidies are in some manner disproportionate to those available in transactions wholly within the private sphere.

To shed any light on that issue, we need to address three sub-questions in particular:

(1) How is the lump sum paid by the private firm at inception allocated among the different property rights it receives?

(2) How are these allocated amounts recovered for tax purposes (i.e., what are the depreciation/amortization rules applicable to them)?

(3) What tax-favored financing opportunities are available to the private investor in such transactions?

With these questions in mind, I will now turn to the Federal income tax treatment of public-private partnership arrangements under present law. State governments are generally not subject to Federal income tax, so I will principally focus on the tax consequences to the private party lessee upon entering into these arrangements. The next three sections address in turn the three questions set out immediately above.

Allocation of up-front payment

It follows from the above description of the overall tax analysis that the large up-front payment made by the private party to the transaction is treated as paid to acquire different bundles of business assets. As a result, the parties must allocate the initial consideration to the following categories: (1) the acquisition of infrastructure assets, such as land improvements, computers, toll booths, and other property used to operate and maintain the highway; (2) a lease of the underlying land; and (3) the acquisition of intangible assets, such as a franchise and license for the right to collect tolls (along with any generally unstated goodwill or going concern value).

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[17] By the same token, an ideal income tax would consider the effect of inflation on the value of capital investments. Whether accelerated depreciation roughly compensates for the failure of the income tax to address the effects of inflation is a topic beyond the scope of this testimony.

The tax treatment of the assets in each of these categories varies. The tax allocation of the consideration therefore will determine the timing of the tax deductions associated with the investment. The tax rules are clear that the parties must allocate purchase price in accordance with the relative fair market value of the assets acquired.[18] The parties to the two large transactions used here as templates allocated a substantial part, and perhaps the bulk, of the consideration paid to the third category above (intangible assets). Whether this allocation was correct is the type of issue that the Internal Revenue Service confronts all the time in the examination of large business acquisitions, and is entirely fact-driven.

It might fairly be observed that the public participant in these sorts of transactions is tax-indifferent (because it is not a taxpayer), but eager to maximize the value of the transaction to the private sector firm (and thereby to itself as well). There thus is unlikely to be a true adversarial negotiation of the allocation of the purchase price. The same observation can be made, however, of many transactions that are entirely within the private sphere, either because the seller is tax-indifferent in this context (e.g., it is a foreign entity, or has large net operating loss carryovers), or because it is a domestic corporation, for which ordinary income and net capital gain are taxed at the same rates.

Recovery of investment (depreciation and amortization)

Depreciation of tangible infrastructure assets

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The MACRS depreciation categories generally are set out in the Internal Revenue Code, and are amplified by Internal Revenue Service guidance.[19]

The MACRS recovery periods applicable to most tangible personal property range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer's depreciation deduction would be maximized. Nonresidential real property and residential rental property are assigned lives of 39 years and 27.5 years, respectively, using the straight line method.

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[18] Section 1060 sets out detailed rules for the allocation of consideration in certain asset acquisitions.

[19] Sec. 168. Rev. Proc. 87-56, 1987-2 C.B. 674.

The most significant tangible infrastructure assets acquired by the private party in a public-private partnership are the highway and any related bridges.[20] As "land improvements," these assets are generally depreciated under MACRS over a 15-year recovery period using the 150-percent declining balance method. The roadbed underlying the highway, however, is treated as having an indefinite useful life, and therefore its value is not recovered through depreciation at all.[21]

Other tangible assets that may be acquired include computers, equipment, toll booths, building structures, and other tangible assets associated with operating and maintaining a toll highway. As with the land improvements, these assets are generally recovered through accelerated depreciation under MACRS using various recovery periods, generally five to seven years, or through straight line depreciation over 39 years in the case of certain structures.

It might be argued that 15-year accelerated depreciation is not the appropriate depreciation schedule for highways or bridges, and Congress could choose to change that recovery period. (The Internal Revenue Service does not have the authority to set MACRS recovery periods.[22]) The MACRS depreciation schedules have their roots in a previous statutory depreciation classification scheme, which in turn was based on economic analyses performed some 40 years ago. It is not always obvious that the MACRS schedules are internally consistent (that is, that they accelerate the depreciable lives of different categories of depreciable assets proportionately to their economic lives). Thus, to take some arbitrary examples, railroad beds are depreciated over 50 years (straight line), and rail track are depreciated using MACRS accelerated depreciation over seven years, while highway roadbeds are not depreciable at all, and the highways themselves are depreciated over 15 years. Commercial airplanes are depreciated under MACRS over seven years. In the absence of quantitative research into the actual useful lives of these (and hundreds of other) asset classes, it is not possible to state as a matter of abstract tax policy whether the MACRS classification of highway assets and other land improvements is appropriate.

To the extent any of these assets were originally constructed or acquired with proceeds of tax-exempt bonds,[23] depreciation is calculated under the alternative depreciation system ("ADS") using the straight line method generally over longer recovery periods.[24] For example,

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[20] In addition to acquired tangible assets, the private party will incur capital improvement costs throughout the lease term. The cost of newly constructed assets will also be recovered through depreciation deductions.

[21] Rev. Rul. 88-99, 1988-2 CB 3. In a public-private partnership transaction, the roadbed is likely included as part of the right-of-way lease of the underlying land.

[22] Most MACRS recovery periods originally were established through IRS administrative guidance (Rev. Proc. 87-56, 1987-2 C.B. 674). In November 1988, however, Congress revoked the Secretary's authority to modify the class lives of depreciable property as part of the Technical and Miscellaneous Revenue Act of 1988. Pub. L. No. 100-647, sec. 6253 (1988).

[23] See discussion of tax-exempt bond financing later in this testimony.

[24] Secs. 168(g)(1)(C) and 168(g)(5).

land improvements are recovered over 20 years using the straight line method if the project is financed with tax-exempt bonds, instead of 15 years under MACRS using the 150-percent declining balance method. The treatment of assets as tax-exempt bond financed property in the hands of the original owner (resulting in use of the longer recovery periods and the straight line method) continues even if the tax-exempt bonds are no longer outstanding or are redeemed.[25] Furthermore, any subsequent owners who acquire the property while the tax-exempt bonds are outstanding are also subject to the alternative depreciation system.[26] These present-law rules tend to prevent taxpayers from arbitraging their tax benefits with tax-subsidized financing.

Amortization of intangible assets

As previously noted, significant value generally is assigned in public-private partnership arrangements to the intangible franchise right; that is, the right of the private party to collect tolls from users of the highway. The taxpayer's rationale for this allocation likely is that the right to collect tolls is the main revenue source and is the primary economic driver of the transaction.[27]

Under section 197 of the Code, when a taxpayer acquires an operating business, any value properly attributable to a franchise right is amortizable on a straight-line basis over 15 years.[28] Additionally, any value attributable to licenses, permits, and other rights granted by governmental units is subject to 15-year amortization, even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely.[29] Goodwill and going concern value similarly are amortized on the same schedule. However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not

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[25] Treas. Reg. sec. 1.168(i)-4(d)(2)(ii)(B).

[26] H.R. Rep. No. 97-760, 516 (1982). State and local governments may redeem outstanding tax-exempt bonds prior to the public-private partnership arrangement so that the acquired assets are not subject to ADS rules. To the extent State and local governments retire tax-exempt bonds and taxable bonds are issued or other taxable debt is incurred to finance the private party payment pursuant to a public-private partnership arrangement, the migration from tax-exempt to taxable financing may result in increased Federal tax receipts.

[27] There also may be some value in a license by the government for the right of the private party to use the name of the highway.

[28] Secs. 197(d)(1)(F) and 197(f)(4). A franchise is defined "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[29] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.[30]

Section 197's 15-year straight-line amortization period applies to a broad class of intangible assets, without regard to whether a different useful life might be determinable.[31] Prior to the enactment of section 197 in 1993, there was a tremendous amount of controversy between the Internal Revenue Service and taxpayers relating to the assignment of value to intangibles acquired as part of a trade or business.[32] Most of the controversy involved the valuation assigned to goodwill, which could not be amortized under prior law. Other disputes in this area addressed the difficulty in ascertaining the lives of intangible assets, including licenses and franchises granted by governmental agencies, and the allocation of consideration to intangible assets with no ascertainable useful life (and thus no amortization).

The 15-year amortization period specified in section 197 is not intended to reflect the actual useful life of any particular intangible asset for which that period is prescribed. Some of those intangibles might have a much longer useful life, others much shorter. The same amortization period is required for all because of concern that taxpayers buying a business that includes numerous intangible assets, all of which together contribute to the success and value of a business, could seek to allocate a disproportionate amount of the value of the ongoing business to shorter-lived intangible assets. The rules of section 197 are designed to minimize the extent to which the Internal Revenue Service must devote resources to review these allocations, given the history of disputes in the area.

Some might argue that 15-year amortization of the franchise is too generous in the context of a toll road, where questions might arise over the appropriate amount to be allocated to the franchise as opposed to the land and easement right-of-way. However, the arrangements may be viewed as no different than many other situations where a government grants a license or right to operate a franchise that might be expected to continue indefinitely (even though such rights might or might not also involve a grant of an interest in land). Moreover, even a monopoly right to collect tolls on a road, with contractual protection against any party being granted a right to build any competing road, might arguably lose value over an unpredictable period of time if economic conditions change (for example, if fewer customers use the road or the economy cannot support high tolls).

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[30] Sec. 197(e)(2). Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Res. Sec. 1.197-2(c)(3).

[31] Pub. L. No. 103-66, sec. 13261(a) (1993).

[32] The GAO estimated in 1989 that the IRS had 1,509 open issues relating to intangible asset amortization deductions with total proposed adjustments of $8 billion. See GAO, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, GGD-91-88 (Washington, DC: August 1991).

It is the case, however, that section 197's 15-year amortization period was itself somewhat arbitrary (or alternatively, a blend of many different economic useful lives from a wide range of types of intangible assets). As such, Congress could decide to impose a different rule for long-term franchises of toll roads, or of public infrastructure assets generally, without doing any violence to the internal logic of the Code. On the other hand, if consideration were given to lengthening the amortization period for intangible assets associated with toll road infrastructure projects, any such proposal would have to be assessed in relation to its potential for complexity, increased disputes between taxpayers and the IRS, and its ultimate effectiveness, in light of the history of section 197 and the potential for a "next generation" of transactions designed to avoid the new rule.[33]

The franchise element of public-private partnerships is similar to other common franchises (e.g., fast-food restaurants, convenience stores, and hotels) in many ways, and the tax treatment of the investment is the same. The rights and restrictions on operating practices, such as the amount of permitted toll increases and required capital improvements, have similarities to the franchisor-franchisee relationship in other franchise settings. One of the main differences between some of the publicly described toll road arrangements and some traditional business format franchises is that the latter typically requires payment of an ongoing royalty, usually based on sales, whereas the toll road agreements may provide for only an up-front lump-sum payment.

Some toll road transactions have been reported to include revenue sharing provisions not unlike the royalty payments of the typical business franchise. These revenue sharing provisions are viewed by some as a method for the public party to share in possible future economic upside from toll collections.[34] To the extent payments are made by the private party pursuant to the arrangement, the revenue sharing payments may be considered "contingent serial payments" and deductible in the year paid or incurred.[35] If a payment does not meet the requirements for contingent serial payments, the amount may be treated as contingent purchase price allocated to the franchise and recovered over the remaining life of the franchise intangible asset.[36]

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[33] For example, if a life longer than 15 years, such as the life of the contract, were required to be used for the intangible rights associated with toll road infrastructure projects, then taxpayers might create contracts of a shorter duration that nevertheless are regularly renewed. As another example, if a specified longer life were designated for toll road franchises, taxpayers might attempt to add business rights in addition to the toll road rights under the contracts, and attempt to allocate greater value to those rights with a shorter life.

[34] GAO, *Highway Public-Private Partnerships, More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest*, GAO-08-44 (Washington, DC: February 2008), 44.

[35] Sec. 1253(d)(1).

[36] Treas. Reg. sec. 1.197-2(f)(2).

Recovery of investment in lease of land

The amount of any up-front consideration allocated to the lease of land is generally deductible to the lessee for tax purposes over the term of the lease under the complex regime of section 467. Very generally, those rules take time value of money concepts into account, and effectively convert the lump sum payment into a constructive loan used to fund a stream of level rent payments.[37]

In most cases, the lease deductions are the least desirable from a present value perspective, because of their longer recovery period (i.e., the term of the lease). For this reason, the Internal Revenue Service can be expected to review carefully the allocation of value as between the less tax-favored assets (the land and possibly the tangible assets, such as highways and bridges) and the more tax-favored assets (the intangible assets, such as the franchise).

Financing the acquisition

The private sector participant in a brownfield public-private partnership arrangement can be expected to obtain debt financing to fund a significant part (perhaps 60 percent) of the large up-front payment common to these transactions, and to fund the remainder with equity.[38] To the extent that the private firm issues genuine indebtedness, a tax deduction generally is permitted for interest paid or accrued during the taxable year.[39] The Code contains several limitations, both timing and permanent in nature, that could affect the taxpayer's ability to claim interest deductions. For example, to the extent interest costs are allocable to capital improvements, capitalization may be required as part of the cost of the improvements and recovered through depreciation deductions.[40] Additionally, interest expense may be disallowed under "interest stripping" provisions if the borrowing is from foreign related parties or if there is a disqualified guarantee under a financing arrangement.[41] The facts and circumstances of the arrangement determine the proper tax treatment of interest on indebtedness.

All of these rules apply with equal force to financing an acquisition that takes place wholly within the private sphere. Brownfield public-private highway partnerships add the additional possibility of using tax-exempt financing for some or all of the debt that the private firm must issue to fund the up-front payment.

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[37] Sec. 467(a).

[38] For this reason, the private participant itself often is a partnership that can raise equity capital from a number of institutional investors.

[39] Sec. 163(a).

[40] Sec. 263A(f).

[41] Sec. 163(j).

Tax-exempt financing: Overview

Tax-exempt bond financing has historically been used by State and local governments to raise funds for infrastructure projects. The remainder of my testimony describes the present law treatment of these instruments.[42]

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because of this income exclusion, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The income exclusion for interest paid on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting systems (e.g., rail and bus) are eligible for financing with the proceeds of governmental bonds. In addition, certain privately-used transportation infrastructure projects may be financed with qualified private activity bonds.

Tax-exempt debt to fund infrastructure

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, and airports. These debt instruments in turn can be secured by the infrastructure assets, or can be "general obligation" debt of the issuer.

One tax policy consideration that follows from the availability of tax-exempt financing to governmental owners of infrastructure is that, when attempting to quantify the cost to the Federal government of the Federal tax subsidies available to public-private partnerships, a complete analysis would also take into account, on the other side of the ledger, the Federal tax subsidy (the exemption from income tax) available to wholly public infrastructure projects, to the extent they are funded with tax-exempt debt.

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[42] A description of tax-exempt bonds for transportation projects generally can be found in Joint Committee on Taxation, *Overview of Selected Tax Provisions Relating to the Financing of Surface Transportation Infrastructure*, (JCX-56-08), July 8, 2008.

While the types of projects eligible for governmental bond financing are not circumscribed, present law does impose restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Where bond proceeds are used to finance property, the use of such property is treated as a use of the bond proceeds. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable "private activity bonds," rather than governmental bonds.

As applied to the archetypal transactions under consideration here, a fundamental consequence of the transfer of the highway infrastructure assets to a private firm is that a purported tax-exempt bond offering used to finance or refinance the acquisition (for example, if the State or local issuer were to lend the proceeds of a governmental debt offering to the private firm and the debt service on the private loan used to service the governmental debt), would be treated as a private activity bond. In the absence of a special qualifying rule, as described below, such an offering therefore would not qualify as a tax-exempt financing.

Private activity bonds

The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[43] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

Private business test.–Under the private business test, a bond is a private activity bond if it is part of an issue in which:

a. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use"); and

b. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[44]

Both parts of the private business test (i.e., the private business use test and the private payment test) must be met for a bond to be classified as a private activity bond. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments.

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[43] Sec. 141.

[44] The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

Private loan financing test.–A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

Changes in use.–A bond issue is an issue of private activity bonds if, (1) as of the issue date, the issuer reasonably expects that the issue will meet either the private business tests or the private loan financing test, or, (2) subsequent to the issue date, the issuer takes deliberate action that causes the private business tests or private loan financing test to be met.[45] A deliberate action affects the taxability of interest from the issuance date, even though it occurs subsequent to issuance. If certain conditions are satisfied, the Treasury regulations allow an issuer to cure a deliberate action by taking a remedial action provided for in the Treasury regulations.[46] Such remedial actions include redemption or defeasance of bonds, alternative use of disposition proceeds, and alternative use of bond financed facilities.

As an example, assume State A issued governmental bonds to build a public toll road and expects that it will be owned and operated by a governmental authority for the entire period that the bonds are outstanding. Five years later, while the bonds are still outstanding, it sells the toll road to a private company. The change in ownership would be considered a deliberate action that affects the tax-exempt status of the bonds. To prevent the bonds from becoming taxable private activity bonds retroactive to the issuance date, State A could use the proceeds from the sale to retire the bonds within 90 days of the deliberate action, or use such sale proceeds to establish a defeasance escrow within 90 days of the deliberate action to retire the bonds at their earliest call date.[47]

Qualified private activity bonds

Qualified private activity bonds are tax-exempt bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[48]

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[45] Treas. Reg. sec. 1.141-2(d)(1).

[46] Treas. Reg. sec. 1.141-12. There are five conditions that are required to be met (1) the reasonable expectations test, (2) the maturity cannot be unreasonably long, (3) the terms of the arrangement that satisfies the private business tests or private loan financing test must be bona fide and arm's length, and the new user pays fair market value for the use of the financed property, (4) disposition proceeds are treated as gross proceeds for arbitrage purposes and (5) the proceeds of the issue that are affected by the deliberate action were expended on a governmental purpose before the date of the deliberate action.

[47] Treas. Reg. sec. 1.141-12(d).

[48] Sec. 141(e).

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[49] Generally, qualified private activity bonds are subject to a number of restrictions that do not apply to governmental bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by annual State volume limitations (the "State volume cap").[50] For calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater.

Qualified private activity bonds also are subject to additional limitations on issuance cost and length of maturity. In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax.[51]

Qualified highway or surface freight transfer facility bonds

In 2005, the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, added a new category of exempt facility bonds, bonds for qualified highway or surface freight transfer facilities.[52] Bonds for qualified highway or surface freight transfer facilities are

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[49] Sec. 142(a). Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); privately owned and/or operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated residential rental housing; and certain private facilities for the local furnishing of electricity or gas. Bonds issued to finance environmental enhancements of hydro-electric generating facilities, qualified public educational facilities, and qualified green building and sustainable design projects also may qualify as exempt facility bonds

[50] The following private activity bonds are not subject to the State volume cap: qualified 501(c)(3) bonds, exempt facility bonds for airports, docks and wharves, environmental enhancements for hydroelectric generating facilities, and exempt facility bonds for solid waste disposal facilities that is to be owned by a governmental unit. The State volume cap does not apply to 75 percent of exempt facility bonds issued for high speed intercity rail facilities, 100 percent if the high speed intercity rail facility is to be owned by a governmental unit. Qualified veterans mortgage bonds, qualified public educational facility bonds, qualified green building and sustainable project design bonds, and qualified highway or surface freight transfer facility bonds also are not subject to the State volume cap, but the Code subjects such bonds to volume limitations specific to the category of bonds.

[51] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and to certain bonds issued before September 1, 1986.

[52] Pub. L. No. 109-59, sec. 11143 (2005). The Administration's budget for Fiscal Year 2005 (released in February 2004), proposed allowing the Secretary of Transportation to allocate $15 billion of tax-exempt bond authority to finance highway projects and rail-truck transfer facilities. In describing the proposal, the Department of the Treasury noted that "[e]conomic growth and productivity depend on a modern, well-connected national transportation network. Allowing a limited amount of tax-exempt private activity bonds to be issued for highway projects and surface freight transfer facilities would encourage private sector investment in these projects." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (February 2004) at 161. The proposal also was included as part of the Administration's Fiscal Year 2006 budget proposals. See,

qualified private activity bonds, the interest on which is tax-exempt. A qualified highway facility or surface freight transfer facility is:

a. Any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code, or

b. Any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume cap. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.[53]

The Code imposes a special redemption requirement for qualified highway or surface freight transfer facility bonds. Under present law, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds.

Qualified highway or surface freight transfer facility bonds may be used as financing for public-private partnership arrangements. However, some commentators have argued that in addition to other limitations, the required use of ADS cost recovery (i.e., straight line depreciation over longer recover periods), as discussed earlier in this testimony, makes these

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Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (February 2005) at 139.

[53] As of July 14, 2008, the Department of Transportation had made the following allocations of the $15 billion in qualified highway or surface freight transfer facility bond authority:

Project	Allocation
Port of Miami Tunnel, Consortium Miami Access Tunnel	$980,000,000
Missouri DOT Safe and Sound Bridge Improvement Project	$700,000,000
Knik Arm Crossing, Alaska	$600,000,000
Virginia I-495 Capital Beltway HOT Lanes	$589,000,000
Texas Department of Transportation Interstate Highway 635 (LBJ Freeway)	$288,000,000
Pennsylvania Turnpike Capital Improvements	$2,000,000,000
Ambassador Bridge Gateway Project - Phase I (Detroit, Michigan -Windsor, Ontario, Canada	$212,600,000
Total approved allocations as of 7/14/08	**$5,369,600,000**

Source: Federal Highway Administration

bonds a less attractive financing option, and that a legislative proposal should be considered to allow accelerated depreciation in these cases.[54]

Conclusion

I hope that my testimony provides useful information on the tax policy issues raised by public-private partnerships with respect to the lease of existing highway infrastructure and their present law tax treatment. I am pleased to answer any questions that the Subcommittee may have at this time or in the future.

[54] Humberto Sanchez, *Roadblocks for P3 PABs; Current Laws Put Curbs on Widespread Use*, Bond Buyer (New York, NY: April 12, 2007). Vol. 360, Iss. 32608, p.1.

COMMUNICATION

Testimony of Representative Sam Johnson (TX)
(submitted for the record)
Senate Finance Committee hearing
Tax and Financing Aspects of Highway Public-Private Partnerships

July 24, 2008

Private Bonds for Modern Roads Act

Chairman Bingaman and Ranking Member Bunning, thank you for holding this important hearing today on the issue of public-private partnerships for highway funding. An important provision was included in the 2005 Highway bill, commonly referred to as SAFETEA-Lu, that called for up to $15 billion of private activity bond financing for highway funding. I had a hand in getting that provision enacted into law and believe that it has started to, and will continue to, provide additional resources and means to build and upgrade roads.

Section 11143 of that highway bill called for private activity bonds to be issued so that public-private partnerships could finance road building. All of our States issue private activity bonds for dozens of purposes from housing to education. Road building has long been considered a fundamental government service to be financed through traditional tax exempt bond issuances backed by the taxpayers of state and local governments. Tight state budgets and even tighter local budgets have pushed these governments to become more innovative in their financing of infrastructure. Bringing in an additional partner – the private sector – to road building is necessary.

As of January 2008, the GAO reported that roughly $3.2 billion of the $15 billion worth of private activity bonds have been issued for road construction. The Texas Department of Transportation is currently working on a project for the LBJ Freeway, partially in my Congressional District, that will be financed with these bonds. As a rapidly growing part of the country, my District needs more and better roads and there just isn't enough traditional financing available to make it all happen in the timeline we need.

Private investment in infrastructure, specifically in this instance roads, does not displace other debt but instead brings both debt and equity capital investments. I want to state very clearly that public-private partnerships are not a "zero sum game" displacing other debt. We have seen incredible demand for Private Activity Bonds to finance housing projects – we know this is an expansion of financing available for these needs, not a "zero sum game". The $15 billion worth of private activity bonds for roads in SAFETEA-Lu, has allowed projects to be financed and into construction rather than relegated to states' "wish lists." The taxpayers of our States just do not have an unlimited capacity to pay for all needed projects through traditional issuances of exempt bonds.

Private investment in infrastructure also brings with it a different view of time horizons and budgets. I am proud of Texas DOT – I think they do a good job. But there are different management styles and expertise that are brought to the table with private investors. The $15 billion worth of bonds that are being issued as a result of the 2005 highway bill are a drop in the bucket of highway funding, but I think some good lessons and innovation will come out of these projects.

The outlook for our highway trust fund is not good. This week the House passed a bill to give the Trust Fund $8 billion from the general fund. I am glad to see greater fuel efficiencies for cars, but it is leading to declining balances for the highway fund at a time when more cars are putting more wear and tear on roads with every gallon of fuel. This is a recipe for deteriorating roads and crumbling bridges. Public-private partnerships will bring additional resources to the table to get infrastructure built.

I continue to believe that the law that came out of my legislation, the Private Bonds for Modern Roads Act, is a path forward to roads being built and expanded with resources and talents that would not otherwise be available.

Thank you Mr. Chairman for this opportunity to submit my statement to the Senate Finance Committee.